Apr. '49

The New York

Certified Public Accountant

Vol. XIX | *April • 1949* | No. 4

Internal Control

In-Service Staff Training

Cost Accounting

Accountants' Reports

Federal Income Taxation

NEW YORK STATE TAX CLINIC

ACCOUNTING AT THE S.E.C.

THE TAXPERT

BOOK REVIEWS

Published Monthly by
The New York State Society of Certified Public Accountants
Single Copy 50 Cents : One Year $5.00

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—From the Certificate of Incorporation.

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Certified Public Accountant

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THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

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VOL. XIX *April · 1949* No. 4

The Lengthening Arm of Internal Control

By GERALD S. KOHL, C.P.A.

THE idea of a system of internal control and check in accounting was conceived more than fifty years ago by public accountants. Its purpose was, figuratively, to lock the stable door before, instead of after, the horse was stolen. The system was originally intended to prevent fraud, to eliminate errors, and to permit an auditor to substitute test-checks for detailed checks whenever a business became so large as to render the latter impracticable. Incidentally, vast numbers of business companies have, within recent decades, grown so large that speed in transaction and pressure of production have obscured the fact that internal control and check is not new. Nevertheless, this and some other of our most useful tools in accounting have been in existence for many years, and are new only in their detailed refinements. Consequently, a re-examination of one of these—internal control—should reveal how it has been expanded and accorded so prominent a place, and why it has become one of the most valuable accounting tools available to the hand of management.

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Reason for Origin

Accounting and auditing received their initial impetus from economic crises and bankruptcies. James McClelland explained this in an address in 1869, before the Institute of Accountants and Actuaries, in Glasgow, which had been formed about fifteen years earlier, when he said,

> "In the midst of crises such as these (the Darien Scheme of 1696-1707 perpetrated by William Patterson, founder of the Bank of England, and the Mississippi Bubble, promoted prior to 1720 by John Law), a necessity arose for qualified and prudent men to look after and take charge of the affairs of parties becoming insolvent, and hence arose the necessity for a calling such as we now profess to follow. . . ."

To this, he added the observation that our own Civil War in the sixties had disrupted business and caused so many failures that,

> "The business of an accountant now became firmly established. . . ."

Since prevention of fraud constituted such an important consideration underlying the early development of accounting, it seems quite logical and natural that the devising of a means for preventing fraud should engage much of the attention of early accountants. Consequently, the latter soon began to design books of record and to arrange

procedures in a manner as would segregate the functions of operation, custody, and accounting. This segregation, accompanied by division of authority and precise assignment of responsibility within a business, reduced greatly the temptation and the opportunity to commit fraud.

Broadening the Scope

These corrective measures met with such great success that the scope of internal control was soon broadened. As early as 1900, Lawrence R. Dicksee pointed out that,

> "This is a matter that may very profitably engage the careful attention of the Auditor, for not only will a proper system of Internal check frequently obviate the necessity of a detailed audit, but it further possesses the important advantage of causing any irregularities to be corrected at once instead of continuing until the next visit of the Auditor."

Ten years later, in 1910, G. S. Pitt also declared,

> ". . . I greatly doubt there is anything in the whole scheme of creation in which methods of internal check should not exist, * * * Accountancy itself, to a very large extent, consists of the art of introducing systems of internal check into things commercial * * * I think the main object of an internal check is to ensure the satisfactory working and management of the business. . . ."

No present day interpretation could be more comprehensive than that, or be better justification for reaching outside of accounting departments and into such departments as purchasing, manufacturing, credit, and sales, which is the practice today.

Who Should Make the Installation?

There have been many conflicting opinions during the past forty years as to how internal control should function. One particularly troublesome question has been who should install the system. Several branches of the field of accounting have regarded themselves as best qualified. Public accountants were the first to be called upon to offer suggestions and to make installations. Later, internal accountants, controllers, systems men, and internal auditors undertook to install systems of internal control. The predominant attitude today, as expressed by the American Institute of Accountants, is that,

> "Management has the responsibility for devising, installing and currently supervising a system of internal control. . . ."

Public and internal auditors, however, are obligated to familiarize themselves with its operation, so as to be able to pass judgment on the adequacy and efficacy of the system. These latter two groups bear the responsibility for seeing that the system is followed in every detail, and that duties are performed in the order planned.

Method of Developing System

In connection with the installation of an accounting system which would incorporate the best principles of internal control, it should be noted that as early as 1906, F. W. Pixley wrote,

> ". . . There are well known general instructions, usually recommended by professional Auditors, which should be carried out in the offices of every company. . . ."

In this connection, it should be noted that there are several methods which have proved successful, among them being questionnaires, organization charts, and flow charts. The last named are looked upon today with increasing favor. Imperfections disclosed in performing regular audits have resulted in the adoption of many improvements. Good books devoted to the specific method for installing a system are scarce, and a book of case studies would be particularly welcome.

What Are the Limitations?

If one would know his strength then he must understand his weaknesses and limitations. Charles A. Smith advised well when he wrote,

> "It cannot be expected to stop shoplifting, nor will it have any effect in preventing the issuance of fraudulent financial statements. It will not guarantee that

proper accounting principles have been applied. . . . It breaks down almost completely when there is fraudulent cooperation between employees. . . ."

A word of caution should be injected at this point, regarding the failure to distinguish promptly between simple errors and a weakness in the system. Inability to distinguish between these two may leave a defect in the system on the one hand, or may result in wasted time or useless forays into dead-end searches on the other hand.

Who Did the Writing?

Early literature dealing with this general subject is scarce and the small amount which exists was written almost exclusively by auditors for professional magazines or as scattered paragraphs in textbooks dealing with auditing. Today, the situation is quite different, because all societies of accounting and allied fields devote considerable space to this topic in their journals; textbooks now give added space to it also. Books dealing with the installation of accounting systems are particularly helpful in that they explain in considerable detail, internal-control requirements of accounting records. Recently, the American Institute of Accountants published a comprehensive booklet on internal control. Up to the present time, the student seeking academic training has been handicapped in his efforts to obtain a thorough understanding of the principles and practices. The usual course of study has afforded him a few minutes instruction in an auditing lecture, and perhaps somewhat more time in a systems class.

What Is Internal Control Today?

As recently as ten years ago, there was very little unanimity in definitions of internal control. For instance, V. Z. Brink, writing in *The Journal of Accountancy* in March, 1939, quoted six definitions, each of which presented a fundamentally different interpretation of the term. Today, the American Institute of Accountants provides an acceptable definition when it says,

> "Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies."

Moreover, it described the characteristics of a system as follows:

> "A plan of organization which provides appropriate segregation of functional responsibilities,
>
> "a system of authorization and record procedures adequate to provide reasonable accounting control over assets, liabilities, revenues and expenses,
>
> "sound practices to be followed in performance of duties and functions of each of the organizational departments, and
>
> "a degree of quality of personnel commensurate with responsibilities."

Accountants' Liability for Internal Control

The extent to which an examination of internal control should be pursued was for many years left to the public accountants' own discretion. In April, 1917, however, there was issued a circular entitled *Uniform Accounting: A Tentative Proposal Submitted by The Federal Reserve Board*. This gave a new and semi-official significance to the subject. In 1934, a uniform accountants' report was approved by the Institute and by other bodies, and in 1939, there was incorporated a clause stating that the accountant ". . . reviewed the system of internal control and the accounting procedures. . . ." This clause imposed a legal responsibility which was further emphasized in 1941, when the United States Securities and Exchange Commission embodied in Regulation S-X a paragraph stating that,

> "In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. . . ."

This regulation is still in effect and on the basis of it, several accountants have been criticized publicly for negligence,

by the Securities and Exchange Commission.

Frederick K. Rabel reports, in the July, 1944, issue of *The Journal of Accountancy,* a Canadian case in which Judge MacLean rendered a decision in which he declared,

> "The auditor should ascertain . . . whether the bookkeeping operates as an internal check, whether it is so intended to operate . . . then the extent and thoroughness of that internal check."

Further evidence of auditor liability is apparent from a letter signed in 1945, by several surety companies and addressed to the Institute. In this, they agreed not to press claims unless there was clear evidence of dishonesty, or of gross negligence on the part of the accountant. As to the clause in the accountants' report regarding internal control, its removal was recommended by the Institute in October, 1948, but only because it had by that time become one of the "generally accepted auditing standards."

Conclusion

In conclusion, it may be said that internal control and check offer an ever lengthening arm which reaches into every department of modern business and supplies management with information which was formerly obtained through personal contact, but which today has become largely unobtainable because large business units have replaced small ones. Fraud and error cannot go long unnoticed where adequate controls are in force. Furthermore, these devices aid public accountants and internal auditors by enabling them to substitute test-checks in place of detailed checks as the latter became impracticable with the advent of large business units.

In-Service Training of Members of the Staffs of Accounting Firms

By RICHARD S. CLAIRE, C.P.A.

STAFF TRAINING in public accounting, as I see it, can be conveniently broken down for purposes of discussion into two aspects. One is the job of bringing the newly hired assistant or junior as rapidly as possible to the point where he can operate effectively with a minimum amount of supervision. The other is the task of keeping the performance of the experienced or senior staff man at a level commensurate with his responsibilities and seeing that he continues to grow and develop. This paper is directed primarily to the first of these two aspects of staff training. In other words, let us consider what is now being done and what probably should be done to expedite the progress of the beginner in public accounting.

Not much has been written on this subject of staff training for beginners. Three or four of the larger firms have been conducting somewhat formal programs but it is probably fair to say that they look upon their efforts as being still somewhat in the experimental stage, and for that reason program details are not widely known. One firm has undertaken formal training for beginners this year for the first time. Discussions which I have had with representative smaller firms led me to believe that, as a rule, they rely principally on training on the job supplemented by the use of staff manuals and periodic staff meetings to bring their juniors along toward senior status.

In some respects the fact that the public accounting profession is comprised of firms of widely differing sizes makes it somewhat difficult to discuss this topic of staff training for juniors and reach any conclusion which might have universal appeal or applicability. On the other hand, the objective of bringing a beginner rapidly to the point where he can operate as an in-charge man should be common to all firms regardless of size and, in my opinion, the means by which such an objective may be attained need not vary too widely. Lack of size may be an excuse but

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never a reason for a do-nothing attitude toward staff training.

Before entering into any discussion of the means by which beginners may be trained, a word or two about the reasons which lie behind the unusual interest at the present time in such training would seem to be in order. I assume that there is no disagreement with the proposition that everyone in the profession is now giving more attention to staff training than ever before.

From the Employer's Viewpoint

First of all let us look at the problem through the eyes of the firm or employing accountant.

Each of us is keenly interested in drawing young men of outstanding ability into the accounting profession and, of course, into our own particular firm. If we are to attract such men we must offer more than a long period of apprenticeship unaccompanied by a planned program of training. The firms that offer the best training rightfully have a big advantage in the competition for the ablest of those who are entering the profession.

Although I must admit that I have never seen any statistics which would prove or disprove this point, there is considerable evidence that those who have invested rather heavily in training for beginners have satisfied themselves that it pays off in the long run. Those who have initiated training programs seem to continue them year after year, and more and more firms seem to be starting them.

Another reason why every progressive firm should provide its juniors with suitable training lies in the fact that the area in which a public accountant is expected to be expert is a continually expanding one. Even a junior is today expected to be more than a figure checker or a vouching expert. As business becomes more complex and intricate, so do the duties and responsibilities of even the beginning accountant. Frequently the men who come directly into the profession from our universities are somewhat surprised to learn of these broadened responsibilities, and the training program of the public accounting firm may have to stimulate this broadening process.

Obviously the universities cannot train men in the specialized requirements of particular firms. Since firms differ quite a bit in their audit working paper procedures and styles, a training program for beginners serves a very useful purpose in this respect.

Finally, and we all hope this condition is only a temporary one, the present shortage of qualified men in the senior and supervisory levels places on beginners an unusually heavy responsibility to be able to carry out certain phases of an audit with a minimum amount of supervision.

From the Beginner's Viewpoint

From the standpoint of the men who are entering public accounting, an attractive training program is an important feature.

These men are today older and more mature. They were in military service during the years in which they normally would have been starting their public accounting careers. Now they're anxious to make up for those years spent in the service. They want to be sure that the public accounting firm of their choice has plans and programs for hastening the day when full responsibility for field work will be theirs.

While they were in the armed services they were impressed by the effectiveness of the training programs that were offered. So, it is quite natural for them now to conclude that a public accounting position is sub-standard unless it includes a program for training beginners. To some the training program is the fringe benefit that tips the scales when deciding which firm to join. Such an appeal carries real weight at these times when salary scales are fairly comparable and there are more positions than qualified applicants.

On-the-Job Training

The time-honored method of training an assistant by assigning him to a job and relying on the senior-in-charge to do the teaching is still unsurpassed, at least in theory, for effectiveness. Certainly classroom teaching, attendance at staff meetings, and study of staff manuals can do no more than supplement the real development that comes from on-the-job training.

However, before we decide to leave everything to on-the-job training we should review some of its inherent weaknesses. Good audit seniors frequently are not good teachers. Even if they have the ability to teach they may not wish to take the time to explain or train; their reputations as seniors are not unrelated to meeting the time estimates for the engagements. If all is left to on-the-job training, some beginners get trained much faster and more thoroughly than others; much depends on the element of chance in assigning assistants to engagements. In many respects it is a slow but sure process; it needs to be supplemented and expedited by other means. Furthermore, if a beginner learns by emulating a senior it seems quite clear to me that the caliber of the senior's work tends to set a ceiling on the junior's performance and that is not always a healthy situation, especially under today's conditions. If something can be done to develop alert assistants to a certain degree before turning them over to on-the-job training, it is really surprising the value that can come to a firm as a whole by having them modestly prodding the seniors with suggestions of newer and better ways of doing the job.

Formally Planned and Conducted Schools

The idea of conducting a school for beginners has been sufficiently widely adopted to warrant devoting more than a small portion of this paper to this training device. Obviously, training fifty beginners presents a different problem from that of training five men. Some will say that the larger group should be handled by a formally planned and conducted school but that a school for five is out of the question. My reaction to such an approach is that a real determination to train the men is all that counts; difference in size of group involves only the details of executing the program.

Assuming that you agree with me that the number of juniors to be trained is of less importance than the will to do the training, let us examine some of the preliminary decisions that must be made early in the planning for a school. Objectives will have to be agreed upon first. Allow me to suggest a few that seem important to me.

A very significant objective that is sometimes overlooked, especially in the case of the larger firms, is that of a program of orientation for the new man. The school should provide something to supplant the old-style initiation into public accounting which consisted of a seat in the unassigned staff room or in the footing and comparing room, plus a bundle of literature to be read. Public accounting depends heavily on teamwork and esprit de corps. The sooner that the new man can be made to feel at ease and realize that he has joined a team, the sooner he will become an effective junior. The mystery about the new job and where the beginner fits into the organization ought to be removed at an early date. Tell him about your organization, its history, its personnel policies, its standards of performance, and what it expects from him. In fact, it's not too early in the career of your beginner to tell him about your firm's policies on certain controversial accounting and auditing questions. He'll admire your willingness to discuss such matters in the open and look upon it as evidence that he is a member of the team. Stress such points as conduct in a client's office and the importance of getting along with other staff men and the

client's personnel. Explain professional behavior to this man who yesterday was a college boy.

At an earlier point in this paper I indicated that the universities can train for auditing work only in terms of generalities; now it's up to you to show the beginner your style and special requirements in matters such as preparation of audit working papers. Teach him your approach to an audit engagement. I think these objectives are the principal ones around which you should build your instructional material, further reference to which will be made in more detail later.

Another objective which deserves an important place in the planning of a school is that of explaining why certain audit procedures are followed and why, under certain circumstances, certain ones may be omitted. Many college graduates seem to be schooled in audit procedures but are lacking in an understanding of the reasons which lie behind the importance of those steps. If, in your school, you can inject into the beginner's mind some understanding of these underlying reasons, you will eliminate much which might otherwise appear to be aimless and unsavory in the auditing routine. As in many other lines of endeavor, things become more interesting as they become better understood.

I'm sure it will be unnecessary for me to elaborate on this next point. Even though you may have hired the best men from your favorite university, your own school can do much in a short period of time to strengthen and extend the abilities of your beginners in auditing techniques.

Use your school as a means of helping the beginner strengthen what is probably one of his weakest points: his ability to write and speak concisely and effectively. This, I might add, is not easy to do.

Now that we have agreed upon some objectives, two other important points remain—operational plans must be set and instructional materials and methods agreed upon.

If your firm has several offices, one of the first questions to be answered will be whether or not to conduct a school in each office, hold regional schools, or have a single centralized school for all offices. I favor the centralized school because, among other things, it will best serve the purpose of fulfilling that important objective of orienting the junior. Furthermore, the centralized school will probably be better planned and arranged. It will command more attention and will be more likely to be carried out in an uninterrupted fashion. Classroom facilities will be more carefully thought out and provided, instructors will be fewer in number so that their preparation and conduct can be more ably supervised and controlled. The whole undertaking will probably run less risk of interference from regular auditing assignments. It goes without saying that the centralized school will involve some costs that could be avoided if the job were to be done by offices.

Selection of faculty for the school is of such importance that perhaps it should have been the first operational consideration. Select men for their teaching ability and their wealth and breadth of experience. Your faculty will make or break your school. Make a faculty appointment a full time assignment and use only men who have reached at least managerial or supervisory status and who like the assignment. These may sound like unnecessarily restrictive qualifying requirements but I'm sure that experience will prove the soundness of my suggestion. If you try to conduct a school with a faculty selected on the basis of availability, your school will have more form than substance and the faculty will consist of a parade of unprepared men pausing briefly in the school between audit assignments.

When to conduct the school and how long to run it are other preliminary considerations. Should the men go

through the school when they first join the firm or should this formal training be postponed until after they have had one season's experience on the staff? Naturally, there is much to be said for each alternative. There is a saving in unit cost if the training is provided only for those who have first demonstrated ability during a busy season and those who look like good prospects for the future. Such men can also be trained more effectively and broadly with the advantage of having first had some experience. However, I think these advantages of the delayed training plan are clearly outweighed by benefits that accrue to the men and to the firm by having them schooled before they are assigned to any audit engagement. In a three weeks' school it is possible to give a man the equivalent of approximately six months' experience on audit assignments. You can't afford to delay this kind of progress.

As to the duration of the school, a concentrated three weeks' period seems to be preferable to following an easier schedule for a larger period of time. Three weeks are more or less required to provide breadth of coverage, but much extension beyond that time may result in a school that is rather dull to men who have just completed four or five years in school and who are anxious to start applying the knowledge they acquired in an academic setting. I think the school should be open to all beginners and a healthy but not over-emphasized air of competition should prevail.

Now that objectives have been set and a qualified faculty has been selected for our three weeks' school, just how should we carry on from this point? Here are a few suggestions.

Divide your group, if it is large, into sections so that ample opportunity for individual help and instruction is provided. I favor instructional groups which number not more than twenty men. I would provide two instructors for each such group, not only because an active group will require that much supervision, but also to bring differing viewpoints and concepts into the discussion. Select with some care the quarters in which you are to hold your school, using regular accounting classroom facilities with plenty of well-lighted desk and blackboard space if they can be obtained.

Do all that you can, within reason, to make it clear to the students that your school is not just a continuation of their college work. Use the lecture approach very sparingly and by all means keep all activity on a realistic plane. With this aim in mind, it would probably be wise to have the students carry through a simulated and abbreviated audit. If it can be done, provide all the records, underlying documents, and supporting evidence that would be dealt with on a real audit engagement. There's nothing that will instill more confidence in a beginner on his first assignment than the experience of having made his first practice run under able and abundant supervision with no client present. Don't just talk about how working papers are prepared. Prepare them and insist on standards of performance fully as high as those to which you expect to adhere on an actual engagement. Review and appraise the work of each student with care, and arrange individual conferences with those whose work is not up to par.

Encourage the men to take part in the discussion sessions which should be held as a sort of critique following the completion of each segment of the work. The quality and quantity of each man's contribution to the discussion will not only give you a line on his abilities as an accountant and auditor but will also provide the clue as to his needs for special help in the area of expressing himself forcefully, clearly, and concisely. Furthermore, lively discussions participated in by many will help to break the monotony of the finger exercises required by the audit practice case.

In some accountng firms the chasm between staff and top personnel is un-

necessarily wide. As a device for narrowing this spread, as a part of the plan for orientation of the beginner, and, of course, for other obvious reasons, I would be sure the students have an opportunity to see and hear from a generous representation of top personnel in the firm. Along this same line, specialists in your firm, such as tax men, systems men, etc., should be brought in as guest speakers to tell these beginners something about the activities in each area of specialization.

As another suggestion for the school, I would like to encourage you to investigate the possibilities of using visual aids, such as slides and projection equipment. They are not only effective teaching devices but they also make it possible to present quickly and easily a wide variety of working paper styles and lay-outs.

Finally, at the completion of the school each man should be rated by his instructors not only as to the quality of his audit work and participation in discussions but also on the score of personal traits that seem to need correction or development. The faculty will have learned a lot about each beginner during the three weeks of close observation, so take advantage of the situation and go to work to build a stronger junior and an earlier senior.

Staff Meetings

Of course we all hold staff meetings periodically and they can serve a very useful purpose. I will deal with this training device only briefly. In my opinion, the only staff meeting that can be truly effective is the one that is carefully planned in advance and is conducted by a well prepared discussion leader. The group should be small, the meeting should preferably be held within regular working hours and, at least in so far as discussion of certain topics is concerned, it may be desirable to break the staff up into groups classified along lines of special interests or extent of experience. Staff meetings should be discussion meetings; I'm satisfied that staff meeting lectures are seldom effective as training devices.

Staff Manuals

I suppose nearly every firm provides each beginner with some kind of a staff manual, ranging all the way from the revised Federal Reserve "Examination of Financial Statements" to the more elaborate manuals that some of the larger firms have prepared for their own private use. Manuals serve a very useful purpose when used in conjunction with other training devices, but I question their value when relied upon almost exclusively to do the training job. They tend to encourage the check-list approach to an audit, an approach that is filled with danger. They foster the textbook slant in solving problems which more properly are resolved by the application of reasoning and judgment.

Dissemination of Current Information

A good staff man is always a well informed man, not only as to current developments in the fields of accounting and auditing but also as to general business conditions, world affairs, and new developments in industry. Acceptance of this premise places a responsibility on each firm to foster and encourage its staff to become well informed. Don't under-estimate the interest of juniors in matters which go beyond the scope of their day-to-day assignments. Sometimes we make the error of believing that only top personnel would be interested in or should be supplied with information about what might be called higher level matters. If you decide that it is important to have a well informed staff, make it easy for the men to get the information. Give each man a copy for his own use; don't just leave it in your library or in a rack in the staff room.

Practical but Not Insurmountable Difficulties

I recognize that some of the suggestions and conclusions contained in this

(Continued on page 245)

Construction Cost Variation

By JOSEPH A. DOWLING

It is the purpose of this paper to state that there can be cost variation in the amount spent for the construction of fixed assets, and to suggest the need for a formulation of some rules for its identification and write-off. Cost variation, the difference between what a product should cost and what it did cost, is most commonly associated with products made for sale. The opinion expressed herein is that it need not be thus restricted: cost variation and its uses can also be applied to the construction cost of an asset for use—a building, or a machine. And, the ultimate purpose of finding a construction cost variation would be that of removing from the total actual cost that part which is deemed to be excessive.

In an article, "Concepts of Cost, Past and Present," written by Professor Theodore Lang in the N.A.C.A. Bulletin of July 15, 1947, there was the following sentence:

> ". . . in fact it may be at once stated that the true cost of the product is the standard cost and that the actual cost is important only to the extent that it reveals deviations from a standard."

In its original context, the "cost of the product" undoubtedly connoted goods produced for sale. If it can be accepted that the cost of producing a building (or a machine) for use is essentially the cost of a product, it must follow that the "actual cost is important only to the extent that it reveals deviations from a standard."

The idea of construction cost variation isn't novel, even though employment of this particular terminology may be unusual. R. B. Kester in his book, "Advanced Accounting" (p. 350), states:

> "probably the maximum amount to be capitalized as construction costs of buildings should not exceed the maximum amount for which the finished structure could have been completed under normal conditions".

A pamphlet published by the Robert Morris Associates and reprinted in part in the January, 1949, issue of *The New York Certified Public Accountant* contains this paragraph:

> "arguments have been advanced that there are unusual costs met in construction,—caused by strikes, delays in getting materials, defective materials and similar reasons,—such excess costs may be charged off. These would thus correspond to manufacturing variances which are charged off as incurred instead of being capitalized in inventory values."

Going beyond the stage of merely advancing arguments, the Hercules Powder Company in its Annual Report for 1947 reported that it had augmented its depreciation reserves by $1,300,000 because "construction projects in the post-war period have generally exceeded the estimates of cost and the time required for completion."

The standard cost of a fixed asset such as a building is what it should cost under ordinary circumstances, with normal efficiency and skill assumed. For the purposes of this discussion, the variation due to changing price levels will not be considered. There is plentiful discussion of that phase of the subject available in current accounting literature, so we shall limit our attention to the factors of cost variation be-

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yond that caused by diminished. purchasing power of the dollar.

Although one does not ascertain the standard cost of a building through the exacting observations of time and motion study, there are engineering studies of probable costs prepared before a construction project is undertaken. These, approved by management, give a fair indication of the extent of value which the management believes it is justified in acquiring to meet future needs of the business. Review of the estimates in the light of actual experience recorded in the costs of the finished project give opportunity for using "hindsight" to correct errors and omissions in the original estimate. A revised estimate of construction cost can reasonably be the standard cost.

If we have a standard cost (the revised estimate), and we have the actual costs, then a comparison of the two will reveal the deviations from standard. Here are some which one may expect to find in construction projects of this post-war period:

(a) *Strikes.* Strikes stop work on a project but do not stop the continuing charges to the project for overhead costs, for technical and clerical salaries, equipment rentals, protection of materials against the elements and against thievery.

(b) *Delayed delivery of materials.* When steel, cements, equipment of other required materials do not arrive on the date needed for steady progress of the work, labor becomes partly or entirely idle. Reduction of a working force during such period of enforced idleness may not be practical, particularly for short periods—it would be just as expensive to try to re-assemble a crew of skilled workmen, and a construction manager may have to proceed with caution in the reduction of his labor force. In any case, some items, as enumerated under "strikes" are of a continuing kind even when direct labor is inactive.

(c) *Bad weather.* In every construction job some bad weather is expected (at least for an outside project) and recognition of the contingency will find its way into the estimates. However, if the weather is exceptionally bad —if heavy rains continue day after day and wash out foundations and cause pumping expense; if freak storms cause damages—there are good reasons for seeking cost variation of the kind we write about.

(d) *Abnormal prices.* We have excluded the changing price level as a factor, but there is still the matter of "gray market" prices. If the needed material cannot be obtained through ordinary sources of supply in a reasonable time there may be a decision to pay premium prices for immediate delivery. A similar condition may exist in respect of labor prices. To attract workers the construction manager may have to pay a premium over the going rate for a particular craft; or to hasten completion overtime premium may be incurred. Work on Sundays and holidays, if not contemplated in the planning of the project, also add to the cost variation.

(e) *Labor inefficiency.* This is probably difficult to measure in a construction project; so must have been the early efforts of industrial engineers to appraise efficiency in manufacturing.

(f) *Mistakes.* A draftsman may err in some detail of his drawing; a construction foreman may err in his reading of the blueprint. If, through errors of this kind, work already completed in part had to be dismantled and rebuilt

correctly, the rebuilding expense is an item of cost variation.

(g) *Miscellaneous.* Defective materials which cause double work, excessive usage of materials, expediting expenses, accidents of a kind not covered by insurance, and, generally, circumstances which cause the expenditure of money, without leaving behind fair value in the project, complete this list.

Establishing the amount of cost variation for a construction project cannot be done with the nicety and precision that is expected in a plant manufacturing the same product month after month. There necessarily will have to be a great deal of judgment and engineering advice used in the process, and allowance made for a fair margin of tolerance in the quality of the estimates. Should the premise of construction cost variation be used to any significant extent, accountants can be expected to evolve procedures for circumscribing it.

Determination of the amount of construction cost variation is somewhat like navigating through unchartered water; so is any statement of how to dispose of the variation after it has been determined. However, these are the possibilities:

Least desirable in the light of the theme, would be a decision to allow cost variation to remain in the book value, there to be depreciated over the ensuing forty or fifty years. It would be a departure from the parallel we have tried to draw between making product for sale and making a product (a building) for use. The cost variation of a product made for sale is infrequently capitalized. N.A.C.A. Research Series #13 (pages 1254 and 1255) indicates 80% of companies in the survey treated variation as a period cost. At the opposite extreme would be the proposition to charge construction cost variation to expense in the year it is incurred. (In providing figures for this, construction expenditures would have to be compiled frequently and compared carefully with estimates.) There are good reasons for a charge-off in the year of occurence; doing so would conform to the parallel of the inventory, and may have some income tax advantage as when the cost variation is of a kind which can classify as a casualty loss under the income tax regulations. On the other hand, there may be no revenues in that particular year, as when a company is first entering business, and possibly the extra costs were incurred to hasten completion and so permit earlier participation in the peak business of the post-war period. In the latter event, the extra costs would apply more equitably to the "peak business" years.

In between the two extremes of (1) deferring the extraordinary costs over the life of the fixed asset and (2) taking it all in the first year, there are several degrees of compromise. Thus, the amount could be set up in a special subdivision of the fixed account and there marked for accelerated amortization (in the manner of public utility accounting, which segregates in account #100.5 and amortizes, separately, elements of the purchase price deemed to be in excess of original cost.) The period of amortization might be two years, three years, or any other relatively short period warranted by the particular circumstances under which the cost variation arose, or dictated by the necessities of the financial policies of the company.

There are collateral considerations of the possible effects on real estate taxes, insurance and income taxes. In respect of real estate taxes, any procedure which removes abnormal costs may well operate to keep the assessed values and the resulting tax at an appropriately lower level. The same is true of fire insurance or other insurance based on insurable value. It would be wasteful to pay premiums for insuring value that doesn't exist. Some may suggest that any procedure which places a standard cost on a building would not

be acceptable to the Collector of Internal Revenue. That is primarily a question for the tax consultant. The work of the accountant is to devise methods which appraise as precisely as possible the effects of economic phenomena, leaving to the tax specialist the burden of any necessary reconciliation between accounting concepts and income tax regulations. Yet, the realization that income tax regulations often do have an impact upon accounting decisions condones some brief excursion into that area. There are cases wherein taxpayers have sought to deviate from actual cost in capitalizing expenditures for fixed assets. Those we use for reference were in the period after World War I, a period somewhat similar to the present.

In *Atwater Kent Manufacturing Company* v. *Commissioner*, 43 F (2d) 331, the taxpayer paid large bonuses to secure quick delivery and incurred overtime labor to expedite completion of the project. These elements were claimed as deductions in the year's tax return. The Commissioner disallowed them and the Board of Tax Appeals sustained the Commissioner, but the Circuit Court ruled in favor of the taxpayer, who had asserted that without such additional costs he would have lost certain seasonal income.

Another case very much like *Atwater Kent* was that of *Frank & Seder, Inc.* v. *Commissioner*, 44 F (2d) 150. $84,372 was expended for excess costs of steel, for additional labor costs due to overtime work, and for bonuses to the architects. Taxpayer deducted this amount in his tax return. Contending that the excess expenditures enabled him to earn income several months earlier than otherwise would have been possible, taxpayer won his case in the Circuit Court.

In the case of *Rankin* v. *Commissioner*, one issue is pertinent to our topic. Strikes delayed delivery of a machine. The mechanic who was engaged to make the installation was idle for 23 days because of the delayed delivery. The taxpayer claimed that the wages and expenses of the mechanic while waiting should be deducted as an operating expense or loss. The Commissioner disallowed the expense and the Board of Tax Appeals sustained him, but again the Circuit Court upheld the taxpayer, reasoning that "where costs arising from an unexpected contingency are as disproportionate to what is normally to be expected as those in this instance, it seems only fair to say they should not be capitalized as a part of the improvement."

So conclude our efforts to point out that cost accounting principles can give useful service in the responsibility of accounting properly for the product cost of durable assets.

The Defects of Cost Accounting Systems, With Some Suggested Remedies

By Pilson W. Kelly, C.P.A.

The General Situation

It will come to you as no news that cost accounting systems vary greatly in effectiveness in different companies, from reasonably satisfactory, down to worse than unserviceable. There are companies of real importance in which all reasonable men agree that the cost system is no good.

It appears that this condition is not caused by accident, but has two definite sets of reasons, technical reasons and professional reasons, which will be outlined.

It seems that the source of difficulty is that the cost accountant's present place in the scheme of things is based upon error, which operates to the great detriment of the accounting profession, the client, the auditor, the cost accountant, the research man, and everybody remotely concerned with cost accounting.

However, let no one tell you what complicated truth really is but only how it appears to him. You are invited to judge for yourself in the light of your own experiences.

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He is a graduate of Stevens Institute of Technology, held responsible posts in the public utilities field, and during the war, headed an Army Ordnance Unit, responsible for determining the costs of large contracts which were indeterminable by usual accounting methods. Mr. Kelly was later Controller of a manufacturing company and has since been engaged in independent practice, specializing in depreciation, and has contributed to the current discussions of that subject.

On the plane of technical difficulty, the hinge of the matter is the number of variables. This takes us into mathematics, the science of variables.

Arithmetic is the science of one variable and accounting, as it now exists, is almost entirely confined in its truly effective use to problems of one variable.

To handle two variables at once, considerably more mathematics is required, algebra, plane trigonometry, analytic geometry, differential and integral calculus. In problems of two variables, the accountant operates under a more subtle disadvantage than possible lack of mathematical knowledge. He just is not generally accustomed to thinking in terms of two variables.

That is why he embarrasses himself so often in the fields of utility depreciation and replacement reserves, where there are two variables, the number of dollars, and the change in meaning of the dollar. The mathematics itself is simple.

It is not much of a jump to three variables, the tools being solid geometry, spherical trigonometry and descriptive geometry, but the increased effectiveness, except in a few fields like navigation and design, is not great.

Four variables take you into Einstein and the fourth dimension, where the explanations seem more complicated than the things being explained.

The cost accountant must deal with thousands and even millions of variables. In industry it is not unusual to

find a piece requiring 100 different operations, and then to discover that it is only one of 50,000 pieces combined in the thing that is sold. Adjust for the continual change in identity of the pieces, the various ways in which the same piece is made, and we get the variables existing ten years ago. Now adjust for the recent changes in the purchasing power of the dollar, and its myriad manifestations, and changed rates of labor performance and a few other things, and it would not be surprising to find a million variables in even a small factory. Logically, it is very discouraging.

But let logic not prove what reason knows to be false. Surprisingly, there are men in the world who can *sometimes* handle millions of variables very easily: statisticians and engineers. They operate by different methods, but they have one thing in common. They don't work by counting the manifestations of each of the variables. They apply insight, that is, they look at the million variables until they understand their nature so thoroughly that it is clear to be seen, if you look at it rightly, that there are only two, or rarely three variables.

Then the statistician takes one of his many kinds of average, refines the results and enunciates them.

The statistician goes into a problem of a million variables, like people dying in different places, for ten thousand different reasons, at a hundred different ages, and produces results which keep the life insurance companies solvent.

But observe that he is careful to confine himself to problems which, by nature, have in reality only two or three variables. In the above case, people are either dead or alive and they die at some age if they die.

The engineer is more subtle and practical. He looks at the problem until he sees among the million variables, only two or three real ones. Then he builds an instrument to measure these, usually using a piece of the variable itself. He has a different instrument for measuring everything, including the atom bomb, and wouldn't be found dead trying to measure everything with one counter, as the accountant tries to do with a cost dollar.

Thus, if a factory has ten thousand lights, each with varying use, of all different sizes and efficiencies, with varying voltage, current and power consumption, a meter boy reads the meter once a month and that is nearly the end of it.

The accountant's single counter, the cost dollar, ties him too closely to one variable, and it seems that the cost accountant will have to employ and develop methods along the lines of the statistician and the engineer. Since the statistician is a historian, except where the past has such a definite pattern that he thinks he has a glimpse of the future, unless cost accounting is to be done as history, as it is sometimes done, rather than as current events and future guidance of management, as it should be done, the engineer seems to be the better model.

To keep costs on these millions of variables, a system is, of course, necessary, but it seems to be easily forgotten that when you have a system, the system has you. Cost systems generally resemble the oriental god, Juggernaut, in their lack of flexibility! He could travel only in a straight line, and any houses in the way had to be demolished.

More specifically, systems are usually single-purpose, to arrive at monthly cost of sales of a range of products, or to determine contract cost. If they succeed in doing this even quite roughly, they are considered very good. But if it is important to determine something else quickly, it is extremely difficult and often claimed to be impossible.

Consider the industrialist whose system was condemned as thoroughly unsatisfactory by the Army, as he pondered over the letters from the British Ministry of Munitions, lavishly

praising his system. One party insisted upon provable current cost of production; the other party wanted provable contract cost.

A week's intelligent cost accounting, which came out of no handbook, made the system equally admirable for both purposes, to the surprise and delight of some important people in the army and in industry.

It seems very clear that no cost system adequately serves management without a feature which few systems possess, that is, an integrated, trained estimating staff.

The accountant has an instinctive distrust and contempt for estimates, and regards book figures as reality and estimates as illusion. It is very easy to prove that sometimes the estimate is much nearer reality than perfectly kept books. All that is needed is enough change in the identity of the product in a long enough production cycle, or changed production methods. This becomes very real on government contracts for items treading the frontiers of science, such as modern wars are fought with, with second-lieutenants producing change-orders by the hundred. New products in peace time travel the same road.

We now turn to some general types of cost systems, with particular attention to complicated metal manufacturing.

Job Cost System

In this system the cost accountant addresses himself to counting each of the manifestations of each of the many apparent variables, by keeping a separate sheet for each job. The "job" is commonly a batch of pieces of the machine being sold, and the economical size of batch is fixed by production considerations.

Material drawn and labor expended on the job are posted, usually as individual occurences. Overhead is sometimes taken into the job cost monthly, and sometimes omitted; a round percentage of labor is commonly used for overhead.

There are usually several, sometimes many, batches of the same part, in different stages of completion.

The chief advantage is that after completion of a job, accurate material and labor costs at least are known. The disadvantages are many.

The cost accountant immediately becomes an historian, often quite ancient. He is in ignorance until a batch is finished; then he is in ignorance until the next batch is finished. Besides, this method requires a great deal of work to follow all the individual occurences.

And if, heaven forbid, demand for the parts is so great that batches must be split, then you gradually go out of the manufacturing business, into the bookkeeping business.

In periods of changing material costs, labor rates, and labor performances, this type of system performs miserably. The writer has seen men of high integrity voting before the President whether to add 10% or 50% to the book figures produced by 100 clerks, to arrive at a proper monthly cost of sales. Some months 10% was used, and some months 50%.

It is hoped to make this article constructive, and the best thing to do with this system seems to be not to use it, except where life is simple and constant, with few products, of few simple parts, made of things which do not vary much in cost. You will have to find such applications for yourself.

The contract cost system, commonly used for government work, is basically a job cost system, in which the contract is the job. By this system alone, nobody knows whether he is coming or going, until the contract is finished. A manufacturer who does not support such a system with a competent, trained estimating staff is inviting worry, humiliation and financial ruin. Such a staff cannot be trained over night. This was one of the greatest

weaknesses in modern cost accounting revealed by World War II.

Process Cost System

This type of system is commonly regarded as very simple, but this belief can be a snare and a delusion. In general, record is kept of the continuous input if ingredients and labor, and of the quantity of product produced. The processes often run to high material but low labor cost, for the laborers are often simply watchmen, who do nothing until trouble develops; and low overhead, mostly power, depreciation and taxes, with a single product, or a small range.

This situation takes on a very treacherous aspect when the one product has dozens of sizes, shapes, thicknesses, coatings or variations, and some of these are always more profitable than others, and it requires real cost accounting to separate the sheep from the goats.

The key to the situation is measurement. Due to the unusual importance of material, if there are not adequate weighing and metering devices, and intelligent use made of them, there simply isn't going to be any sound cost accounting. The engineers of the client, by nature lovers of measurement, may have adequate measuring devices for coal, rock, oil and the like, but don't take it for granted. They may need the accountant's clamor for these things in addition to their own, to get them.

An interesting and important thing occurs when the accountant needs some measurement for cost accounting which the engineer doesn't need to operate the factory, as happens when total flow is measured, but flow to individual products is not measured.

A cost accountant was presented with a problem of this type once, in the form of a variance of 25% in $100,000 per month use of a powdered material in $200,000 per month sales of finished product, which was a sandwich of powder in paste form, between sheets of many various sizes and kinds of fibrous material. He was solemnly informed that management would like to see a medal go for the solution of the variance, which ranged from +25% to —25%, and had been a mystery for thirty years.

The problem was solved in three days' work, with variances against measured physical inventory of ½ of 1%. The thickness varied due to wide commercial tolerances in the finished product, and nothing stayed constant over 10 seconds at a time. Hand controlled speed changes occurred every few seconds to maintain consistency of paste, by judgment. However an ordinary revolution counter placed upon a conveyer screw, after calibration, caused all mystery to collapse of its own weight. The cost accountant is not always so successful. Sometimes he fails.

The Standard Cost System

This seems to be a step in the right direction, and in some quarters is the holy cow of cost accounting. However, it clearly has feet of clay.

In this system, each operation is time-studied, and this is expensive. Five or six operations a week is commonly the output of a good time study man. Very often an incentive system based on this is used to pay the workmen. From the material necessary, and the time study, a standard cost of each part is arrived at.

Immediately the cost accountant is released from the confines of history. He can look ahead. As long as things remain fairly static—the product, production methods, material and labor rates, and labor performances—this system works like a charm, in metal manufacturing. But when these things change enough, the variances make the whole thing unbelievable. So new standards are set, at great expense.

This brings the chief accountant a subtle form of torture. He can't use the old standard very long in figuring the monthly cost of sales, because he knows it is wrong. The new standard

is not much better because, for months, he will be selling pieces actually made at the old standard, or some prior standards. So, for months, he has to work between the two standards, new and old, as best he can. He uses approximate over-all percentages, on the basis of guess and hope, and consoles himself with the thought that it is only a matter of time until the new standards, too, run themselves into the ground.

Trying to be constructive, one can suggest better estimating assistance, but to really get at the bottom of the trouble, one should consider the Bedaux systems.

Bedaux Systems

Consult a dozen authoritative works on cost accounting and find that Bedaux does not appear in the index of most, and where reference is made, it relates to wage incentives only.

It seems very clear that engineer Bedaux placed a powerful tool at the disposal of the cost accountant, which is little appreciated and less used.

By means of his work, it is possible to apply insight to the million variables in machine shop labor, and to another million in the dumping ground called overhead, and prove before the world that there are really only two variables, viz., the number of Bedaux units, and the cost of a unit. This tends to pull the whole thing down where the accountant can handle it.

In effect, these systems do not keep costs in dollars, which bear little natural relation to shop work, but rather in Bedaux units, or minutes of work, determined by time study. These bear a very natural relation to shop work.

It cannot be said that this type of system is a cure-all. It requires great humility and keen intelligence to operate it. Both the best and the worst systems the writer has ever seen were Bedaux-type systems.

Without exhausting the subject, and indeed hardly scratching it, let us consider a few of the difficulties.

The first is time study. This must be of a very high grade, and particularly familiar with the methods, traditions, customs and even philosophies of the particular shop under study.

Then comes honor, though it should come first. If management is going to make the time study man cut the "B units" every time a workman makes a decent week's wages, there is going to be no good cost accounting. Many incentive systems have foundered on this reef. However, where honor holds the reins in management (and some exact addresses can be furnished) unions have been known to clamor for the Bedaux system.

A suggestion is offered concerning the next weak spot. Bedaux-type accounting systems have been accused of partaking of the nature of horse technology, wherein the difficulty of distinguishing the horses is neatly overcome by simply counting their legs and dividing by four.

More specifically, the "B units" get us away from the thousands of variable standards of the standard cost system, but somebody has to determine what the "B unit" costs, and this is commonly done by intelligent guess. This is often the chief problem of the man who rides behind a Bedaux accounting system.

This problem seems to lend itself to remedy, by the application of inventory methods to the "B units" and it is possible to keep the variance between the inventory per Bedaux and inventory per general books, at the end of any month, down to a fraction of one month's actual variance of labor and overhead put in process, without any guessing.

The Bedaux systems have been no more successful with material than any other system. This problem is still awaiting insight, to bring down the million variables. Where products are sold as large identities, such as automobiles, locomotives, and the like, analysis of the chief material components, coupled to index trends, preferably

home-made, should bring this problem under better control. However, the material problem is often less serious than the labor-overhead problem, for the usual condition encountered is likely to be a ten-cent bar of steel, with a dollar's worth of labor and overhead on it.

A distinguished figure in cost accounting has observed that Mr. Bedaux was gathered unto Osiris before his work was completed. This is, of course, no reason why other men, granted the opportunity, should not be willing and able to plant the flag further up the slope.

There is another consideration. The docility of captains of industry in accepting statements on the fifteenth of the month, is very surprising. In what other activity of man does it require 50% longer to find out what was done, than it took to actually do the work? The Bedaux approach can be a powerful lever against this problem.

Some Professional Considerations

Most professions resemble the painting known as "The Spirit of '76", the grandfather, father and son, in that they fall naturally into three general divisions, Construction, Operation and Inspection, and Research. This division is so founded in truth that most industrial concerns have separate departments devoted to these activities, often with separate vice-presidents.

It is generally expected that these activities are going to cost some money, and that they are all not only beneficial, but essential. Nobody expects a gas works or an automobile factory to rise by itself.

Furthermore, there is not only harmony between the three divisions, there is a high degree of cooperation. The mechanical engineer graciously introduces the construction engineer, when there's a building to be put up. The medical specialist gladly presents the surgeon, and so on.

These welcomers present their colleagues in related but different lines, without the slightest shame or feeling of inferiority, and even the patient doesn't expect the brain surgeon to operate on him for five dollars because that is what the medical man charged a roomful of office patients.

These men realize that everyone is served when things are set to rights. They know that they do not know everything, and are adult enough to know that nobody expects them to know everything.

In accounting, it is different. Every way you look at it, cost accounting is the opposite of auditing, and the things that make a good cost accountant are the opposites of the things which make a fine auditor.

Consider unswerving reliance upon authority. An auditor proceeds always as the agent of accounting authority, in the form of accepted accounting principles. In cost accounting there is a conspicuous lack of effective authority. The cost accountant does better when he uses the facts of the particular business as authority.

Consider aloofness from clients' personnel, so essential to the auditor, on the wise principle that the oldest conspiracy in the world is that between the thief and the thief-catcher. The cost accountant gets his best ideas from questioning the operating staff, especially lathehands, and the like.

Consider profound knowledge of machine shop practice, incidental to the auditor, but the life-blood of cost accounting.

Consider routine, a large part but certainly not all of auditing. Cost accounting is pioneering, chiseling everything out of rock, with no two companies having the same pattern of problems, and no last year's work to use as a guide.

It clearly appears that auditing and cost work are different kinds of work, but the auditor understands himself so imperfectly that he is under the delusion that somebody, exactly who we

can't find out, expects him to know all about all kinds of accounting, including cost accounting. A real expert operates the other way, gradually learning more and more about less and less.

But the auditor often welcomes the cost accountant like the plague. To begin with, no matter how rotten the cost system becomes, he often will not call on the cost accountant until he is about to lose a client, or an audit has become unprofitable, or he has to be primed for what promises to be a most embarrassing board meeting, or stockholders' meeting.

Then he would like to operate in camera, with hypothetical data, in the field of general principles. Failing this, he would like to smuggle the cost accountant in and out as something he shouldn't need.

Occasionally, to the credit of enlightened and professionally mature specialists in auditing, the cost accountant is brought in as a fellow-technician. Then the client develops the hallucination that a cost accountant is a species of tradesfallen auditor, not to be paid much. How he reconciles this with the concept of a super-service he desperately needs, does not appear.

Due to our ineptitude in handling this simple problem, the accountant is being driven out of cost accounting. You will have to judge for yourselves whether the accounting profession can afford to lose cost accounting. There is nothing to prevent plumbers' helpers from calling themselves cost accountants. Even corporations engage in it. These have the advantages of advertising and soliciting, over the C.P.A. It seems odd to regard these as advantages, but at least corporate practitioners and business engineers get access to a volume of work.

Until accountants understand this situation better, and take remedial steps, it seems unreasonable to expect clients to have connected ideas on the subject.

These professional considerations seem to be the real things which are holding cost accounting down at the level you find it. True, there are technical problems, but if the cost accountant had his rightful place in his own accounting profession, he would not be sure of brilliant success in solving these problems, but instead of working himself out of work with one hand, and trying to line up another job with the other, he could address himself to these problems with his entire soul.

What Price Standard Costs?

By Charles M. Ross, C.P.A.

Some months ago, the National Association of Cost Accountants published a Research Bulletin entitled "A Re-examination of Standard Costs" (Vol. XXIX, No. 11). After tracing the historical development of standard costs from its beginnings in the scientific management movement early in this century, it went on to outline the conflicting views and opinions regarding the uses of standard costs and applications thereof. Wide differences of opinion existed at the First Annual Conference of the N.A.C.A., held in 1920, as to the real value to management of standard costs, and differences of opinion have continued uninterruptedly for the past 28 years. These conflicting views are reviewed again, as of February 1, 1948, and this latest examination winds up with a concluding paragraph:

> "For all purposes, the usefulness of standard costs will be much influenced by the care with which they have been set and maintained. Many instances of failure to use them and of management's expression of a desire for actual costs rather than standard costs reflects a lack of confidence in the standards. If they are known to be purely guesses, to be set at an unrealistic level, or out of date, management may justifiably question their reliability and doubt the wisdom of spending money on them."

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Mr. Ross was graduated from the School of Commerce, Accounts and Finance of New York University in 1920. He has had considerable experience as a management consultant.

The Chinese have a proverb that "one picture is better than a thousand words." Following that sage advice, there is presented here a brief picture of some of the problems faced by standard cost accounting as exemplified by the case of a concern that recently "went broke."

One of our clients was approached by a New England manufacturing concern and asked to make a substantial investment in that company. We were requested to make a survey of its affairs and to find out the reasons why it was losing money, notwithstanding large sales volume and urgent public demand for the product which it was turning out.

We made the survey and, as part of our study, saw the workings of a standard cost system when a concern finds itself unable to do things in the tidy, test tube environment so neatly set forth in the textbooks and handbooks on standard costs.

During World War II, the company had been engaged in work for the government. Thereafter, faced with the necessity of finding a new product for its large plant facilities, it decided to manufacture a single household article on an assembly-line basis. It engaged competent engineers and cost accountants to design complete production flow procedures. Time studies were made as to estimated labor requirements for each production step. Material requirements for each part and sub-assembly were prepared and standard costs established. Plant overhead was budgeted and amounts chargeable to costs at varying stages of production levels were determined. Bookkeeping procedures called for the keeping of accounts in terms of standards and variances, rather than on what is called the memorandum plan, in which the comparison between standard and actual is

not part of the formal records, but rather as a statistical analysis.

What happened? Well, the sales department and the experimental laboratory found that they had to change the product continuously in order to remain in the competitive picture. These frequent changes necessitated a new bill of materials as changes occurred, and also had a bad effect on the labor standards due to change-overs which prevented a smooth flow of work. Overhead allocation became useless as a guide to cost control, as they had no way of really budgeting sales of old and new models.

Material standard costs were set up on January 1. We were in the plant in the middle of October. No changes in the standards had been made. But in the intervening nine and one-half months, the Purchasing Department, hampered by fantastic gyrations in the price of raw materials had been buying merchandise (a) in uneconomic quantities, (b) with slightly different specifications, as urgent substitutes, (c) at very high prices for certain parts, and (d) at unexpectedly low costs for certain articles bought from war surplus. The bookkeeping department had a staff of clerks engaged in the laborious job of identifying the standard material cost portion of each incoming invoice to arrive at material variances. How they determined the *significance* of the material variances (whether due to inefficiences, model changes, price changes, etc.) we never found out, because we distrusted the analytic work being done on the purchase invoices. To illustrate, let me tabulate some relevant figures taken from the September 30th Profit and Loss Statement:

Sales	$3,933,000
Cost of Sales, at Standard	3,393,000
Material Price Variance	4,300
Material Usage Variance	14,200
Labor Variance	31,300
Overhead Variance	324,900
Cost of Sales—Actual	$3,767,700

The material price variance of $4,300 is a very poor representation of the actual facts. Material costs represented 70% of Cost of Sales at Standard (according to budget data examined by us) or approximately $2,500,000. Inquiry disclosed that the variance was a net figure in which variances arising from war surplus, bought at very low prices, were offset against variances arising from purchases over standard. As the war surplus sources were not replaceable, only a misleading net total is the result. Of what use to management are such data?

The company used the Lifo method of handling inventories. The purpose of Lifo is to charge current operations with the most recently purchased articles, which in a rising material market means the highest cost merchandise. But here, the increases in material costs wind up in a Variances account, to call attention to the apparent "inefficiency" of the Purchasing Department.

In the example here presented, the company adopted the standard cost method on January 1, 1948, and the inventory at the beginning of the year was set up at standard (although tax returns cannot be prepared with such a basis of valuation). Consider the adjustments which are involved in closing the books at December 31, 1948. They affect the current year's operating results through the closing of the Variances account to the Cost of Sales. Another problem arises as to whether a portion of the variances should go to work-in-process and finished goods inventories at the year-end, in order to place responsibility on the Purchasing Department for true costs in computing the next period's profits.

But these material variances—by reason of the fact that the net total is a composite of plus and minus, arising out of a multitude of factors, many of which will not recur—ought not to appear as a bookkeeping figure. Rather, a comparison of the actual costs with the statistical data, compiled by competent Production and Purchasing De-

partment executives, which these executives have kept current, would appear to offer every advantage which management requires without the bookkeeping splitting of invoices to arrive at variances.

When we come to the labor variance of $31,300, we have another meaningless figure. Consider these sharp fluctuations in unit production, by models, in a three-month period:

	Model A	*Model B*	*Model C*	*Model D*
April	1691	2332	241	-0-
May	890	1379	543	-0-
June	138	803	2274	72

How would one go about measuring the efficiency of operations "by a systematic comparison of actual performance, with a standard," when no orderly planning of sales was possible in the confused circumstances which prevailed in this particular company and also in this industry, and which has been general throughout practically all industry in recent times. Does the visible future look like a period of orderly smooth sailing in which stable standards will be possible of achievement? The labor standards set up were predicated on an even flow of work, on conveyor belts, untroubled by interruptions caused by model changes, or consumer non-acceptance of certain models necessitating abrupt stoppage of work, or inability to obtain needed materials with resultant work stoppages. Under these circumstances, any figure for labor variances is merely the arithmetical difference between the labor total and the standard set up—and thus an index of nothing.

It is true that the comparison of actual labor costs with a yardstick, or standard of expected performance is an indispensable part of production control. This discussion relates to the advisability of accumulating variances as part of bookkeeping procedures, and not the abandonment of comparison of actual versus expected costs. Because of the complexity of the problem of setting up standards which will really be in tune with the problems in the factory, it must be evident that a mechanical bookkeeping comparison will not be of sufficient value to warrant the analytic time spent in dissecting *each* posting to arrive at variances.

A few illustrations of labor standard problems may be apropos. An impending strike will disrupt routines and production results as the result of the undercurrent of smoldering resentment. The actual strike demoralizes production. If the results of the work stoppage produce a bad settlement for the workers (according to their view), the undercurrent of resentment lingers on for a while. If the strike is settled on a basis regarded as favorable to the workers, there will be a sudden spurt in production giving the appearance of an apparent increase in efficiency.

Or there may be a cut-back of work, resulting from a falling off of new bookings. Workmen, fearful of an impending lay-off, may quietly produce a "stretch-out" in order to stay on as long as possible.

If a new wage agreement is impending, other factors come into play; a desire on the part of the workmen to show especially good results may produce really striking efficiency for a time, although not based on any fundamental changes.

Finally, consider Labor's long-standing antipathy for labor standards determined by management, as leading to the "speed-up". How futile it would appear to be to spend time each day segregating actual labor costs into two piles to determine variances when there is no real hard core of stable facts on which to stand as regards the standard. How much simpler it is to arrive at labor standards in separate computations—adjusting them as special circumstances dictate and make comparisons with actual results per books.

The above mentioned overhead variance total of $324,900 is a sizeable variation. It, too, is a meaningless figure. Overhead allocation had been estimated on the basis of steady evenly-planned production. But instead, the plant had

no opportunity to get into any sort of flow. Not only did the component parts of the overhead gyrate; the unit production did the same. The production schedule used as a basis on January 1 was unrealistic by April 1; and by September 1, was hopelessly out of line. Consider the irritation to executive management on finding a confusing overhead variance total of $325,000, representing more that a 60% increase over standard for that item, thrust at them on an operating statement, and the sense of bafflement at attempts to evaluate its significance, other than the obvious one that it was too high.

The question may now be properly asked: what is the purpose on the part of this writer in asking the reader to accompany him through a jungle of accounting irritations? At the outset, the statement was made that this concern "went broke"—and surely that alone should cast the greatest doubt on the value of data obtained from such a source. After all, the vast majority of concerns with cost systems (whether on a standard or actual cost basis) do *not* go under. In addition, this company did not fail because of the standard cost system; there were plenty of other factors.

But we had an opportunity to see the vast amount of time spent in expensive and useless analysis; of time which should have been spent in establishing a sound and effective stock room control (which was in a ghastly condition); of time which should have been spent in establishing production control by units as, for example, the big wall boards devised by concerns specializing in management tools. And this misdirected effort undoubtedly contributed to the over-all confusion, rather than as an aid to management.

From the foregoing brief recital, it might appear that this writer holds the view that the use of standard costs as a tool of management is all wrong, and should be radically modified or completely abandoned. Such a conclusion would not be correct. Undoubtedly, there are hundreds of concerns where the standard cost system, as part of the regular books of account, works well; where standards are stable and are kept current with actual conditions, or the product lends itself to orderly routine classification as, for example, concerns which manufacture for stock and sell from catalog. This article is intended to illustrate the point raised by the N.A.C.A. itself, as outlined at the beginning of this paper, that failure will result if the installation of a standard cost system is not carefully geared to realities and, above all, kept current.

However, this writer does feel that, in a great many cases, the assembling of standard cost data as a supplement to the historical cost information, and not as an integral part of the bookkeeping work, is the preferred method. Generally speaking, it is only in a static business or a static period of economic activity that it is possible to set up long-range bookkeeping cost standards.

Where a concern has a backlog of orders at all times in sufficient amount to produce a smooth flow of operations, working against a standard may function well. However, if there is such a backlog, there is no need for laboriously compiled data; the merchandise is already sold. Accordingly, as management must wait for the historical cost—and it had the standard cost at the instant it set it up—the continuous break-down of each item may not produce sufficient operating information to warrant the effort.

Monthly Reports and Reports Other Than Audit Reports

By J. LEONARD PENNY, C.P.A.

CONSIDERATION of the subject assigned for this paper develops a series of thoughts and ideas which are submitted for serious exploration to the members of our profession.

Accountants' reports of any type are an expression of the facts, findings, and recommendations or opinions developed in the course of an investigation undertaken as a professional engagement by members of our profession. Our services divide themselves into two broad classes of activity, namely:

> Investigations, either annually, quarterly, monthly, or at irregular intervals, for the purpose of examining financial statements and submitting reports containing the financial position or condition and operating results of an enterprise for a period of time, accompanied by the accountant's opinion or comments relative thereto.
>
> Investigations, for the purpose of developing other reports which may encompass any and all phases of business financial condition, operations, management controls, labor problems, etc., which the accountant is qualified to handle and which are for special purposes to inform owners, management, creditors, and others with respect to information which properly answers the problem in the mind of the persons or person who initiated the assignment.

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As these two broad subdivisions of our professional activity become fixed in our minds, other considerations grow therefrom. Some of them follow.

Bulletin 23, issued by the American Institute of Accountants in December 1947, entitled "Clarification of Accountant's Reports When Opinion is Omitted" has reference to reports issued in connection with examination of financial statements, balance sheet and statements of income and surplus. This paper is concerned largely with other types of reports.

Representative members of our profession possess today, as the result of education (college and/or university training) and experience, a broad working knowledge of accounting, auditing, business and accounting systems, finance, economics, commercial law, the function of money, labor and management in business, and are qualified to serve business owners and management not only with respect to developing accountants' standard form of audit reports but to actively assist them, within the proper limits of our professional activity, to obtain the data to properly guide and assist them in the solution of their many problems.

The tremendous scope of business activity which confronts management is suggested by consideration of the specialized courses dealing with business subjects which are offered by our leading universities, and by consideration of the many specialized association groups which are concerned with business activity in addition to our own, such as national and local cost accounting groups, the Controller's Institute, tax groups, management groups, and many others too numerous to mention.

Many of us here present might be startled to learn the percentage of time expended in their own organizations on these special business problems as compared with time expended on regular audit engagements. Data regarding the percentage of time so expended, if tabulated and made generally available to our group, would be of extreme interest. This field of activity is large and challenging. Successful and satisfactory completion of special assignments develops that splendid feeling of satisfaction which always results from the rendering of a constructive service.

Investigations are for the purpose of developing facts to be used for various purposes. In this connection, consider for a moment a statement regarding facts which was made twenty-one years ago by Owen D. Young, which, if fully comprehended by practitioners, particularly the younger ones, would enable many problems to be satisfactorily solved which often seem difficult of solution because of incomplete or unreliable factual data. Mr. Young said:

> "Facts can be applied in any field. Our curse is ignorance. Facts are our scarcest raw material. This is shown by the economy with which we use them. One has to dig deep for them for they are as difficult to get as they are precious to have."

Too much emphasis cannot be placed on the importance of facts as the basis for our reports.

Monthly reports, as used in the title to this paper, have reference to monthly reports of financial condition and operations and can be considered in two categories: namely, monthly reports carrying the accountant's name and opinion, or a report without an opinion prepared in accordance with Statement on Auditing Procedure No. 23, and monthly reports prepared on plain stationery by a public accountant as a service to management without any representations with respect to the accuracy of the statements. With respect to the Monthly Audited Reports, except in special instances, it is not economically sound for a client to arrange for such service. Where such occasion for required service does exist, the same standards of audit procedure should apply as are applicable to annual audit reports, issued either with or without an opinion relating to the statements. With respect to preparation of monthly reports from which the accountant's name is omitted, a broader field for service exists. This service can consist of (1) either regular preparation of reports from (a) submitted trial balances or (b) a limited examination of a client's records, or (2) initial preparation of reports coupled with education of a client's own employees for the purpose of training them to develop the reports. The value of these reports to a client is, in either case, in direct proportion to the care used by the accountant to develop a report which conveys the maximum amount of usable information in the most concise fashion possible, and to develop techniques and controls for the client which will result in accurate data to be embodied in the report. Additional service can be rendered to a client of an even more valuable nature by intelligent analysis of monthly reports for the purpose of reporting to clients on the significant trends which are developing in their operating or financial conditions. Many clients submit copies of their monthly reports to their professional accountants for study and comment. Those who are concerned with the problem of monthly and interim reports will find

three papers of interest in the July, 1948, issue of *The New York Certified Public Accountant.* These papers, which are listed hereafter, were presented at a meeting in New York on May 12, 1948, sponsored by the New York Society's Committee on Monthly Audits, and are as follows:

> The Interim Audit Report for Credit Purposes, by Sidney Lichter, CPA.
> Interim Reports—An Aid to Business, by Jerome B. David, CPA.
> Suggested Inventory Procedures on Interim Audit Engagements, by Kermit J. Berylson, CPA.

Now, with respect to reports other than monthly reports and audit reports. Let us term them for our purpose, Other Accountants' Reports. The American Institute of Accountants, in its Accounting Research Bulletin No. 9, defines accounting as follows:

> "Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions, and events which are, in part, at least, of a financial character, and interpreting the results thereof."

The *Accountants' Handbook* has this to say with respect to financial statements: "The underlying function of financial statements (reports) should be conceived by the accountant to be the presentation of significant information about an enterprise to interested parties to whom 'significant information' may mean different things. Statements are prepared to meet:

1. Requirements of management in controlling operations and securing credit.
2. Requirements of investors, present or prospective.
3. Requirements of governments, federal and local, in connection with tax and other governmental matters."

At first thought, one might believe that services rendered by accounting practitioners other than in connection with audit examinations and reports on financial condition would be limited to the smaller business entities because the larger business organizations have their own staff of accounting and business experts. This is not entirely true for the broader contacts and experiences of the public practitioner equip him to serve constructively the larger business units in many ways. Experience indicates that in numerous situations internal reports in use fail to serve the purpose for which they were inaugurated or else they are outmoded and no longer serve any useful purpose, and in addition vital data which should be available are not being developed.

Alert and intelligent observation during an audit examination will provide avenues of constructive service in connection with the examinations and reports discussed hereafter. The field for constructive service to smaller business entities, not equipped with expert personnel, is broader, of course, than in the case of the larger units.

Requirements of Management

Consideration of management's problem of controlling operations and securing credit develops the following phases of business activity for which management requires reports and which present wide areas of professional activity:

1. Adequate and properly balanced financing.
2. Maintenance of properly balanced financial ratios, such as amounts represented in cash, receivables, inventories, plant, etc., in relation to current obligations, long-term debt, and stated capital.
3. Maintenance of proper operating ratios in relation to past experience and the experience of competitors.
4. Personnel problems—proper number of personnel, measurement of labor's productivity, measurement of labor turnover, proper provision for replacements of key personnel, etc.
5. Problems of distribution of product—markets, selling prices, sales policies.
6. Problems of procurement—sources of material, present markets, possible future markets, etc.
7. Problems of production—costs, mechanization of operations, desirability of piece rates for labor, departmental costs, product costs, expansion or retraction of items in the line.
8. Problems of general office procedures, accounting system, adequacy of personnel for work assigned to them, possible economies, etc.

9. Problems of forecasting future requirements and problems based on intelligent budgeting.
10. Problems of internal control.
11. Problems of taxation.
12. All other problems of management, and they are legion.

Constructive service to management can be rendered by our profession in the areas of activity indicated. In many cases, the service will consist of investigations leading to original reports on the subject matter being considered together with instructions and forms for future internal development of the data which it is considered should be available at regular intervals.

A few case studies of this special phase activity are submitted to indicate the nature of some special assignments.

During the base period years, a manufacturer was engaged in the fabrication of three distinct lines. Volume was good, but profits were negligible. Arrangements were made with professional accountants to make an exhaustive analysis of the operating results. Factual data were developed relating to production and costs which involved various reallocations of costs and overheads which had not been intelligently distributed, and a detailed analysis was made of the markets for the three products. This investigation resulted in a decision to discontinue one of the three lines. Facilities used by that line were converted to the use of the other two and over-all operating results improved very materially in a short time thereafter.

In a recent situation, the management was complacent regarding its situation due to continuing satisfactory profits. In the course of a discussion with its accountants, it developed that unit production was declining, and selling prices were being increased faster than unit costs were increasing. Expansion of the discussion led to an investigation which developed the facts that (1) units being produced were diminishing, (2) selling prices were being raised to compensate for the loss of unit volume, and (3) no accurate method of developing unit costs existed. By pointing out that some industries were already restored to a competitive basis and those who had reached that situation and were unprepared due to neglect of real sales effort and costing procedures were developing serious troubles, the management became very enthusiastic regarding an investigation to develop analyses of sales and a suitable system of cost finding and estimating.

All practitioners have experienced fascinating investigations in connection with proposed financing and the securing of credit in situations where management has afforded opportunity for accountants to undertake a general investigation and report on the history, financial condition, products, personnel, facilities, etc., of a company.

There is no need for amplification of potential constructive service we can render to assist management in the solution of its problems. All that is required is professional fidelity to obtain the facts and facility for reaching sound conclusions which are of material assistance.

Requirements of Investors

Some of the most interesting engagements and reports occur in connection with development of data for the investors, present or prospective. Basically, the data desired for investors are the standard form of audit report and/or a detailed audit report in many instances. Other forms of reports prepared for investors have been analyses of stated capital and surplus, analyses of property accounts, analyses of products, analyses of markets, etc.

A few case studies of engagements for investors are described as illustrative of the field for special service.

A few years ago, a banking institution became "locked in" with a substantial loan to a company which was experiencing difficulty in carrying on a profitable operation. The bank was in

possession of current audit reports but requested its accountants to assist them to determine whether to loan more money in the enterprise or adopt alternative methods to recover its funds. Instructions were to investigate and report on personnel, costs, sales distribution, and methods and analyze the pros and cons of continuing the venture or liquidating it, and to expedite the work as much as possible. As a result of the accountant's investigation, which included many conferences with the bankers and management, a decision was reached to liquidate at as early a date as possible in order to salvage what was left before further losses were incurred for all concerned.

Another case involved a prospective merger of two companies located in different cities. Accountants for the company which was initiating the merger talks were invited to visit the competitor. After a preliminary discussion, they were requested to make an original investigation and report for the competitor, who had not previously used the services of professional accountants. Thereafter, reports were exchanged by the companies for study. After a series of discussions between them, the merger was temporarily in abeyance by inability of shareholders of each to agree on a basis for exchange of securities in the merger. The accountants were requested to submit a plan or plans for equitable distribution of the shares of the surviving company, if the merger was consummated. This they did, taking into account asset values, earning power, etc., and in their report set forth clearly the reasons underlying the suggested basis. The accountants' recommendations were adopted.

Another interesting case involved two clients engaged in different lines of activity. Company "A" owned a substantial block of the stock of Company "B" but not control. "A" desired to sell its holdings in "B" to the shareholders of "B." Several months spent in negotiation failed to develop a meeting of the minds. Both companies were clients of the same accounting firm. The accountants were requested to submit a stock valuation report. Their report set forth three possible valuations for the shares, together with an exposition of the factors used in development of the values. Shortly thereafter, the sale was consummated, using one of the valuations contained in the accountant's report.

Requirements of Governments

Reports prepared in connection with matters of federal and local taxation and other governmental regulations are well known to all of us. Some of the more common types of investigations and reports accountants have made are:

Investigations of depreciation rates and policies.

Investigations of invested capital.

Investigations of base period earnings.

Special analyses of various business factors and business cycles for purpose of excess-profits relief claims.

Special analyses of government contracts.

Renegotiation reports.

Reports for the Federal Trade Commission.

Reports for wage and hour commissions.

Reports of valuations for inheritance and succession tax matters.

We can, as a profession, be proud of the acceptance of and reliance on our reports prepared during the past war for contract termination, renegotiation, and other purposes, and we should be jealous of the reputation possessed which caused these reports to be accepted in many instances with little or no investigation of their accuracy by government officials.

Conclusion

In conclusion, these general thoughts are expressed relative to Reports Other Than Monthly Reports.

1. Audits and audit reports are necessary and serve a required and useful objective, and will always be an important phase of professional activity.

2. Most of our attention as a professional society is directed to that activity. Witness the fact that, with few exceptions, accounting and auditing research bulletins are concerned solely with auditing procedures and statement structure.

3. The field for service by our profession, in addition to our activities as professional auditors, is large and not adequately explored by us.

4. Professional accountants possess, or should possess, the intelligence to decline assignments in the field of Reports Other Than Audit Reports in any situation which any individual practitioner is not qualified to handle properly. More damage is done by incompetent handling of an engagement than we comprehend—witness the numerous cost system installations which do not develop the desired data and result only in unwarranted expense to a client.

5. Care must be exercised in special engagements to develop, *factual* data as the basis for our reports and to submit, in our reports, data dealing with the significant matters clearly set forth. We should avoid conclusions which are not supportable by facts and correct reasoning.

6. Adherence to the thoughts expressed in items four and five can and should develop reports which practitioners can sign and submit with pride.

In-Service Training of Members of the Staffs of Accounting Firms

(Continued from page 224)

paper may be branded as ideal but unworkable. Cost is prohibitive, your work schedule is too heavy to allow for any frills, your staff is never available for training because of out-of-town assignments, and so on ad infinitum. In conclusion, I'd like to express some thoughts along these lines.

Don't undertake to do a training job unless you're thoroughly sold on its benefits and merits. If you initiate a training program give it stature and look upon it as equally important as an audit engagement. If it is just a device for absorbing lost time, the quality and effectiveness will be questionable and the results will be discouraging. Training costs will seem high as they are incurred but they represent an investment in the future of your firm, a kind of insurance that men are being developed to replace your top personnel today. A bit of ingenuity will reveal ways of meeting the problem of training your staff men even though their out-of-town assignments are frequent and of long duration. Where there's a will, there's a way. The degree of success which will accrue from any training effort is definitely tied to the enthusiasm and planning behind it, not just to the details of how it is carried out.

Research and Development Costs

By JACK R. MILLER

INTRODUCTION

WE have it, on acceptable authority, that uncertainty over the attitude of the Bureau of Internal Revenue towards the deduction of research and development costs is a deterrent to industrial research.[1] This uncertainty is said to arise from lack of clarity in the tax law, but it is probably no less inspired by administrative practice that does not appear to square with the decisions. That such practice is in line with business accounting principles simply means that a palliative has been granted; uncertainty over the economic life or death of the taxpayer remains.

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Practically everybody agrees that the preferable method of removing this uncertainty is by statute; and certainly every business man would have it removed by a statute providing for tax treatment of research and development costs according to business accounting principles.[2] Proposals vary from a statute that would permit current deduction of all research and development costs[3] to one that would grant the taxpayer an option to deduct or capitalize in accordance with a classification system consistently followed.[4] To date, Congress has not seen fit to do anything except lend an attentive ear to these proposals, although hope is high that action will be forthcoming in 1949. It is probable, however, that any action taken to clarify the law relating to research and development costs will not be in the form of a taxpayers' field day.[5]

[1] Vannevar Bush, Science the Endless Frontier 16 (1945).

[2] These principles are not uniform, however, and will vary between industries and between businesses within the same industry. Suppose, for example, that a business operates an experimental department for the purpose of developing patentable items. "Some accountants are of the opinion that the entire cost of the department may be capitalized as the cost of the patents obtained; others take a more conservative position, and advocate keeping cost records so that the costs applicable to work which results successfully in a patent can be capitalized and the remaining expenses can be charged to revenue. Others take a still more conservative position and advocate charging the entire expense of the department to operations because competing concerns are presumably operating similar departments and the expense of the department is essential merely to keep abreast of the times." Finney, Principles of Accounting—Intermediate 367-368 (3d ed. 1946).

[3] Hearings before Committee on Ways and Means on Proposed Revisions of the Internal Revenue Code, 80th Cong., 1st Sess. 1436 (1947); Vannevar Bush, op. cit. supra, note 1, at 16.

[4] Reports of the Special Tax Study Committee to the Committee on Ways and Means 26 (November 4, 1947). See also Hearings, supra, note 3, pp. 1371, 1525, 1583, and 1819.

[5] Cf. Minority Report of the Special Tax Study Committee to the Committee on Ways and Means 25 (November 3, 1947).

That no action was taken on research and development costs in the Revenue Revision Bill of 1948 (H.R. 6712)[6] would indicate that, at least on Capitol Hill, clarification of the law on this subject is not regarded as urgent. Indeed, it is entirely possible that nothing will be done about it in the Eighty-first or subsequent Congresses. Accordingly, it seems appropriate to analyze the tax law on deductibility of research and development costs, with a view to determining (a) wherein the law is not clear, and (b) whether any feasible lines of action might be taken to obtain, *through the courts,*[7] the clarity that is lacking.[8] Feasibility of such action may, to some extent, be indicated by the present policy of the Bureau of Internal Revenue. Therefore, this analysis has been divided into two parts: PART I—WHAT WILL THE BUREAU PERMIT? and PART II—WHAT CAN THE BUREAU REQUIRE? (i.e. the status of the decisional authorities.) Inasmuch as such costs must, under certain circumstances, be capitalized, a brief review of various methods of capitalizing them has been added as PART III—HOW TO CAPITALIZE RESEARCH AND DEVELOPMENT COSTS.

PART I

WHAT WILL THE BUREAU PERMIT?

Results of research and development known to be successful

Although there are no published Bureau rulings on the subject, the general policy of the Bureau has been to permit taxpayers to deduct or capitalize the costs of successful research and development in accordance with their established accounting procedures.[9] Of course, an isolated research and development expenditure here or there down through the years would probably not be deemed sufficient to provide an "established procedure", because of the latent possibilities of tax avoidance. But where research and development constitute normal activities of the taxpayer, and where the procedure established reveals no ulterior tax motives, the Bureau will *probably* defer to consistency, apparently recognizing that over several years any tax advantages of one year will ordinarily wash out in a following year. Why the Bureau has maintained this policy in the face of decisions seemingly to the contrary (to be discussed below) is not known. One reason might be the Bureau's realization that conservative business accounting principles demand such a policy;[10] that, under Section 43 of the Internal Revenue Code, the Commissioner has considerable discretion in determining when deductions should be taken in order to clearly reflect income.[11] Another reason might be an unofficial acquiescence in the theory that Section 41 merely requires the taxpayer's books to be kept plainly, honestly, straightforwardly and frankly, rather than accurately.[12] At any rate, there exists an informal hangover of the option to deduct or capitalize costs of research and development which was granted by

[6] Introduced in the House of Representatives on May 26, 1948. This bill should not be confused with H.R. 4790, which ultimately became the Revenue Act of 1948.

[7] The Supreme Court has never passed on the question of deductibility of research and development costs, although certiorari was denied on one occasion. Forest Products Chemical Company v. Commissioner, 294 U.S. 726 (1935).

[8] Cf. Gutkin and Beck, Tax Accounting v. Business Accounting, The Emasculation of § 41, 79 J. Accountancy 130, 138.

[9] Butters, Taxation and New Product Development, Harvard Business Review 452 (summer 1945).

[10] Paton, Accountants' Handbook 130 (3d ed. 1943).

[11] "Whether items should be capitalized and depreciated or deducted in one year as expense is an important phase of the question when deductions should be taken." 2 Mertens, Law of Federal Income Taxation 124 (note 19).

[12] Huntington Securities Corporation v. Busey, 112 F.(2d) 368 (C.C.A. 6th. 1940); Osterloh v. Lucas, 37 F.(2d) 277 (C.C.A. 9th, 1930).

Article 168 of Regulations 45, 62, and 65.[13]

Much of the uncertainty over Bureau policy arises in cases where the taxpayer has no established accounting procedure for research and development costs. If a small business has recently been organized, and its research and development have been concentrated on one or two projects, it is probable that the Bureau would not permit the costs of these activities to be deducted, if the results were known to be valuable by the end of the year. On the other hand, if a large business has recently established a research laboratory for the purpose of improving its products, the Bureau may decide to allow costs of operating the laboratory to be deducted, notwithstanding that some success has resulted from the experiments. Although Bureau action cannot be accurately predicted here, the chances of obtaining approval of the deduction of such research laboratory costs will be stronger if their deduction is common practice among similar businesses similarly situated.[14] While it has been pointed out[15] that the Bureau's policy is highly uneven among different companies in the same industry, the fact may have been overlooked that at least some of these differences resulted from favorable Bureau rulings on requests by the companies for approval of methods *geared to their own peculiar financial conditions.*[16] For example, an airframe manufacturer having diversified activities which insure annual income may prefer to deduct current research and development costs, whereas another airframe manufacturer, going through the planning and tooling stage, would prefer to capitalize research and development costs and charge them off during subsequent income years.

Results of research and development known to be unsuccessful

Where research and development costs are, with the Bureau's permission, being currently charged off, it naturally makes no difference taxwise whether they are charged off as "expenses" or as "losses". They are deductible in either event. However, where the taxpayer's procedure (self-imposed or Bureau-imposed) is to capitalize research and development costs, and where the results of such costs are known to be unsuccessful at the end of the taxable year, the Bureau will permit them to be deducted only as "losses" under Section 23(e) or (f)

[13] Article 168 read as follows: "Depreciation of drawings and models.—A taxpayer who has incurred expenses in his business for designs, drawings, patterns, models, or work of an experimental nature calculated to result in improvement of his facilities or his product, may at his option deduct such expenses from gross income for the taxable year in which they are incurred or treat such articles as a capital asset to the extent of the amount so expended. In the latter case, if the period of usefulness of any such asset may be estimated from experience with reasonable accuracy, it may be the subject of depreciation allowances spread over such estimated period of usefulness. The facts must be fully shown in the return or prior thereto to the satisfaction of the Commissioner. Except for such depreciation allowances no deduction shall be made by the taxpayer against any sum so set up as an asset except on the sale or other disposition of such asset at a loss or on proof of a total loss thereof." The option was removed with the promulgation of Regs. 69 in 1926.

[14] Cf. Use of practices in similar businesses in establishing requirements of competition for purposes of § 102, I.R.C., and in proving reasonableness of salaries of corporate officers under § 29.23(a)-6(3), Regs. 111; Patton v. Commissioner, 168 F.(2d) 28 (C.C.A. 6th, 1948).

[15] Butters, op. cit. supra, note 8, at 453.

[16] Cf. § 35.722-2(b), Regs. 112 (rules for determination of constructive average base period net income): "In general an industry may be said to include a group of enterprises engaged in producing or marketing the same or similar products or services under analogous conditions which are essentially different from those encountered by other enterprises. The mere similarity of product and marketing methods, however, is not enough of itself to comprehend taxpayers satisfying such conditions within the same industry. Factors such as geographical location, character of raw material, supply, and other conditions under which operations are carried on must be considered."

of the Internal Revenue Code. This means that the taxpayer must be able to *prove* absolute failure or abandonment of an experimental project during the taxable year.[17] Merely charging the cost of the project off on the books will not be enough.[18] Deductibility must await some identifiable event, signifying failure or abandonment, such as scrapping of an experimental model and destroying the drawings,[19] or a memorandum of a decision by corporate officers.[20] If additional work is to be performed in a later year, and if hope for ultimate success is not unreasonable, there has not been "abandonment." [21]

Results of research and development indeterminate

As has been related above, where results of research and development are known to be successful, the Bureau will *probably* permit the costs thereof to be deducted in accordance with the established procedure of a taxpayer normally engaging in research and development. If the results are so indefinite as to be incapable of evaluation, the probability that the Bureau will permit such a taxpayer to deduct research and development costs is, if anything, somewhat stronger. Where the taxpayer has no established procedure of accounting for research and development costs, however, Bureau action is unpredictable. Here, as in cases involving successful research and development, a showing that it is common practice in business similar to the taxpayer's to charge off costs of research and development having indeterminate results, would probably be given great weight.

PART II

What Can the Bureau Require?

Results of research and development known to be successful

Although it was recommended in 1920 that the amount expended for preparation of drawings and working models, filing fees, attorney's fees, and traveling expenses to and from Washington "leading up to and securing a patent" should be charged to capital account,[22] it was not until 1925 that any decisions were handed down on the question of deductibility of research and development costs. In that year, the Board of Tax Appeals rendered two landmark decisions which, because they overruled and led to withdrawal of the option theretofore furnished by the Treasury Department,[23] should be considered in some detail. In *Gilliam Manufacturing Company*,[24] the Commissioner determined profit from the

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17 Homer L. Strong, 14 B.T.A. 902 (1928) (failure of experiments); Perine Machinery Co., 22 B.T.A. 450 (1931) (abandonment of project). Cf. Coalinga-Mohawk Oil Co. v. Commissioner, 64 F.(2d) 262 (C.C.A. 9th, 1933).

18 Portland General Electric Co., P–H 1947 T.C. Mem. Dec. Serv. ¶ 47,299 (hydro-electric projects).

19 Dresser Manufacturing Co., 40 B.T.A. 341 (1939).

20 Acme Products Co., Inc., 24 B.T.A. 194 (1931). The fact that the data obtained from the experiments was "still available" made no difference in the Board's finding that abandonment had occurred.

21 See Acme Products Co., Inc., supra, note 20, at 196. But cf. Dresser Manufacturing Co., 40 B.T.A. 341 (1939), where the taxpayer sought to develop a gas compressor engine. In 1931 it designed and began developmental work on an "Engine No. 1". Late in 1933 "Engine No. 1" was abandoned, but in 1934 an "Engine No. 2" was designed and developed, because need for a gas compressor engine still existed and because the taxpayer was still "hopeful that it could develop one which would be practical and efficient". The Board found (p. 344) that there was little similarity between the two engines, but that knowledge acquired through the experiments on No. 1 had been utilized in working on No. 2. Nevertheless, all the costs of developing No. 1 were held to be deductible in 1933.

22 A.R.R. 98, 2 Cum. Bull. 105.

23 Art. 168 of Regs. 45, 62, and 65, which was withdrawn upon promulgation of Regs. 69 in 1926, is quoted supra, note 13.

24 1 B.T.A. 967 (1925).

sale of taxpayer's patents by excluding from the cost thereof amounts alleged to have been expended in their development. Commencing in 1911, the taxpayer (a saddlery equipment manufacturing corporation) employed a mechanical engineer to work out problems in manufacturing and to experiment with and develop a new automobile top and supports for automobile tops. A designer was also employed, along with seven other men, to assist in connection with the experiments. All of these men devoted about half of their time to this work. Salaries paid prior to August 31, 1915, amounted to $31,640. Additional expenditures were made for materials and overhead. In August, 1915, the taxpayer set up on its books, as a capital charge representing the cost of the patents acquired (or pending) prior to that date, the amount of $10,000 as a conservative estimate of the expenses incurred in connection with the development and procurement of the patents. The Commissioner excluded the $10,000 from the basis of the patents on the ground that the taxpayer had originally deducted this sum as expense. The Board held for the taxpayer, saying (p. 970):

> "... If the amounts expended were actually paid out in acquiring patents, the deduction of such amounts as ordinary and necessary expenses of carrying on a trade or business was not proper. The fact that a taxpayer did deduct such items or considered them as expenses does not alter the situation. Such treatment was erroneous. The taxpayer has no option to treat expense items as capital or capital expenditures as ordinary and necessary expenses of carrying on a trade or business and had a right, as it did, to change its erroneous accounting methods. The patents, when acquired, formed a part of the capital investment of the taxpayer and the costs thereof were not ordinary and necessary expenses of carrying on its trade or business. The amount of $10,000 set up by the taxpayer on its books on August 31, 1915, is as much a part of the cost of patents as the attorney's fees or other expenses incurred in the actual procurement of said patents."

The second case was that of *Goodell-Pratt Company*,[25] which was in the business of manufacturing and selling tools. It had for many years maintained a separate department for the purpose of working out new ideas and developing new tools, patents, secret processes, methods of manufacture, and special machinery. The expenses of the department consisted largely of salaries and amounts paid for consumable materials. From 1909 to 1916 the taxpayer expended $260,513.26 in developing certain patents, secret processes, methods of manufacture, special machinery, and new tools; in developing foreign markets; in gathering and compiling information relative to such markets; and in establishing agencies. This sum had been charged to current expenses and deducted on income tax returns for those years. The taxpayer then sought to include the $260,513.26 in its invested capital for the years 1917, 1918, and 1919. The Commissioner held, in accordance with Article 843,[26] that the taxpayer was not entitled to do so because, as a matter of good accounting, it was *optional* whether such expenditures were charged to capital account or treated as cost of current operations; that, having elected to treat them as cost of current operations, the taxpayer should not be permitted to rescind its election. The Board held for the taxpayer and, after quoting from its opinion in the *Gilliam* case, said (pp. 33-34):

"What we said there should be a

[25] 3 B.T.A. 30 (1925).

[26] Art. 843, Regs. 45 and 62, provided, among other things, that where a corporation had charged to current expense (under the option granted by Art. 168) the cost of developing or protecting patents, no amount in respect thereof expended since January 1, 1909, could be restored in computing invested capital.

sufficient answer to the question presented in the case at bar. It applies with equal force in every case where the taxpayer, through erroneous accounting practices in years prior to the inception of the profits taxes, recorded on its books, as ordinary and necessary business expenses, expenditures made in the acquisition of additional assets, whether of a tangible or intangible nature. The Revenue Acts have consistently excluded such expenditures as deductions in computing taxable net income, and the fact that the taxpayer has deducted them in its income-tax returns, without any revision of that action by the Commissioner, does not bar their restoration to surplus upon a *clear showing* that they were in fact capital expenditures." (Italics supplied.)

The Board then went on to say (p. 35): ". . . we believe that from the standpoint of good accounting no right ever vested in any business enterprise to treat certain expenditures according to either of two diametrically opposed theories." From the opinion, it appears that a "clear showing" that the expenditures in question were in fact capital was made by establishing, in retrospect, the success of the results: namely, the growth of the taxpayer to a position of leadership in its industry, with a line of 2,000 different tools, all manufactured in its own plant, marketing its products throughout the entire world.

Subsequent decisions have uniformly adhered to the principles laid down in the *Gilliam* and *Goodell-Pratt* cases. In the case of *The Beaumont Company*,[27] one of three affiliated companies had incurred expenses in connection with the development of patents. A deduction for these expenses was taken on the consolidated return, but the Board affirmed the Commissioner's disallowance of the deduction (p. 823) ". . . for the reason that expenditures for the development and in the acquisition of patents are properly capital expenditures." (Citing the *Gilliam* and *Goodell-Pratt* cases.) Advances to a subsidiary for experimental purposes were held to constitute capital items in *Dempster Mill Manufacturing Company* v. *Burnet*,[28] while in *John F. Canning*[29] costs of experimental and testing activities in developing a formula were held to be capital expenditures. The cost to a corporation of sending its president and a chemical engineer to Europe to investigate a process for producing acetic acid was held to be a capital expenditure in *Forest Products Chemical Company*.[30] In *Hazeltine Corporation*[31] the Board upheld the Commissioner's refusal to allow deductions of $41,363.92 for patent applications and $36,681.26 for patent interferences, saying (p. 122) that it had held "in numerous cases" that the cost of developing patents and secret processes was a capital expenditure, which the taxpayer had no option to treat as ordinary expense. Research laboratory costs were held to be capital expenditures in *Claude Neon Lights, Inc.*,[32] where some twenty engineers were employed to do research in electricity, rare gases, and tubular lighting. The purpose of this research was twofold: to improve its existing product; and to develop new ideas on tubular lighting. In 1927 the laboratory work was done in a space partitioned off from the general shop, but in later years it was conducted in a separate building. Laboratory expense for the fiscal year 1927 amounted to $11,358.66; for 1928,

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[27] 3 B.T.A. 822 (1926).
[28] 46 F.(2d) 604 (App., D.C. 1931).
[29] 29 B.T.A. 99 (1933).
[30] 27 B.T.A. 638 (1933), affd. without written opinion (C.C.A. 6th, 1934), cert. den., 294 U.S. 726 (1935). Accord, Acme Products Co., 24 B.T.A. 194 (1931).
[31] 32 B.T.A. 110 (1935). See also Ward v. U. S., 32 F. Supp. 743 (1940).
[32] 35 B.T.A. 424 (1937).

$7,699.37; and for 1929, $46,472.76. Of these amounts, approximately 50% in 1927 and 1928, and 60% in 1929, represented salaries of engineers; the balance was for rent, traveling expenses, electricity, and laboratory materials. As a result of this experimental research, the taxpayer filed patent applications in 1928 and 1929 on the basis of which patents were issued in 1929, 1930, 1931, and 1932. The Board held that under these circumstances the laboratory costs could not be deducted currently, but should be exhausted over the life of the new patents. Two comparatively recent memorandum decisions indicate that the Tax Court still considers research and development costs to be capital expenditures. In *Magnetic Analysis Corporation*[33] it was held that expenditures incurred from 1930 through 1936 in developing machines for magnetic testing of steel were capital; and in *Viber Company, Ltd.*,[34] it was held that experimental costs resulting in patents were capital, to be exhausted over the life of the patents.

Although it is unlikely that the Tax Court can be persuaded to overturn such a long line of precedents, especially in view of the weight which is given to the Commissioner's determination in accounting matters,[35] it is possible that the protective armor which has been placed around the deductibility of costs of successful research and development may yet be pierced—if not in the Tax Court, perhaps in one of the Federal District Courts or the Court of Claims.[36] Possible vulnerability is indicated by the principle of *Marsh Fork Coal Company* v. *Lucas*,[37] where the taxpayer was allowed a current deduction for costs of electric locomotives, mine cars, and steel rails. The principle accepted by the court was that capital expenditures represent the cost of *increased earning capacity*. Three tests were prescribed, any one of which determines whether the principle applies: (1) Did the expenditures increase output? or (2) Did the expenditures decrease cost of production? or (3) Did the expenditures add to the value of the plant? The court found that neither test (1) nor test (2) was satisfied, because the only purpose and effect of the expenditures in question was to *maintain* the capacity of the mine as the working faces of the coal receded. With respect to test (3), the court, admitting that it was possible to think of the increased trackage and increased number of cars and locomotives as an "increase" in capital investment, said (p. 85) that the trouble with such a theory is that it ". . . leads to the ridiculous result that, with the increase of investment, the property becomes less valuable, and that, when the investment is complete, the property is practically worthless." The court continued:

> "The fact that the trackage laid down and the cars and locomotives installed may last for a number of years is, we think, immaterial. However long they may last in the mine, they are but maintaining the mine capacity, which would otherwise have been impaired by the lengthening of the tunnels due to the removal of the coal. While not repairs they are in the nature of repairs, in that they are necessary to maintain the operation of the mine at the level of normal production. As suggested by counsel, a new axle on an automobile is no less a repair and chargeable

[33] P-H 1943 T.C. Mem. Dec. Serv. ¶ 43,180.

[34] P-H 1944 T.C. Mem. Dec. Serv. ¶ 44,332.

[35] See Note, Accounting Principle v. Tax Practice: Treatment of Deferred Credits and Reserves, 61 Harv. L. Rev. 1010, 1021.

[36] But cf. United Profit-Sharing Corporation v. United States, 66 Ct.Cls. 171 (1928), where the court cited the Goodell-Pratt case approvingly in holding that certain expenditures for advertising could be restored to invested capital even though deducted from gross income in prior years.

[37] 42 F.(2) 83 (C.C.A. 4th, 1930).

to expense because it has a normal life of more than one year."[38]

The fact that Article 222 of Regulations 45 then permitted the cost of mine cars, trackage, and the like to be charged to expense where necessary to maintain normal output,[39] may have been an additional factor affecting the court's decision. At any rate, the principle that capital expenditures represent increased earning capacity has been followed in several other coal mine cases,[40] while in *Libby & Blouin, Ltd.*,[41] it was applied to permit a current deduction of over $12,000, representing the cost of some 2,400 replacement copper tubes of a sugar evaporator. Although these tubes admittedly would last for two or three years, they were regarded by the Board as merely "small parts of a large machine" used for repairs to keep the machine in efficient working condition.[42] The *Marsh Fork* principle would not require much stretching to cover the research and development costs of a taxpayer constantly engaged in improving its facilities and products for the purpose of keeping abreast of competitors. Suppose that a soap manufacturer's sales fall off as a result of a competitor's product that makes washing a pleasure because it gets clothes cleaner faster. In order to *maintain* its sales, this manufacturer must improve its product. Suppose further that research is carried out in its laboratory, as a result of which its product is improved to the point of making washing a pleasure because it too gets clothes just as clean and just as quickly as the rival product. Sales are consequently restored to normal levels. Must the costs of this laboratory research be capitalized? Let us apply the tests prescribed in the *Marsh Fork* opinion:

(1) Did the expenditures increase output? *Answer*—No.

(2) Did the expenditures decrease cost of production? *Answer*—No. If anything, the improvements in the product required additional costs in production.

(3) Did the expenditures add to the value of the plant? *Answer*—No. Although it is possible to think of the improved soap formula as an "increase" in capital investment, this "increase" merely restores the decline in value of the plant that had resulted from the rival product.

The conclusion would be that the costs in question are currently deductible notwithstanding the fact that their results were successful.

It is recognized that many of the

[38] Cf. Hearings Before Committee on Ways and Means on Proposed Revision of the Internal Revenue Code, 80th Cong., 1st Sess. 1363 (1947); International Shoe Co., 38 B.T.A. 81 (1938), where it was held that the Commissioner erred in refusing to allow the current deduction of certain amounts paid for lasts, dies, and patterns, and in requiring such amounts to be charged to capital account and depreciated over a two-year life. The Board found that the average useful economic life of these items was not in excess of one year; that 98.6% of the shoe styles were changed at least every season; and that the expenditures were not made to expand production, but merely to enable the taxpayer "to keep abreast of the times and to present merchandise to the public that had sales appeal."

[39] The Regulations now provide for deduction of expenditures for equipment and replacements necessary to maintain the normal output solely because of the recession of the working faces of the mine, and which (1) do not increase the value of the mine, or (2) do not decrease the cost of production of mineral units, or (3) do not represent an amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made . . ." § 29.23(m)-15(b).

[40] United States v. Roden Coal Co., 39 F.(2d) 425 (C.C.A. 5th, 1930); Commissioner v. Brier Hill Collieries, 50 F.(2d) 777 (C.C.A. 6th, 1931); West Virginia-Pittsburgh Coal Co., 24 B.T.A. 234 (1931).

[41] 4 B.T.A. 910 (1926).

[42] But cf. Ratterman, P-H 1948 T.C. Mem. Dec. Serv. ¶ 48,130, where cost of a dictating machine, purchased for use in lieu of a stenograher's services, was required to be capitalized.

research and development costs of a taxpayer constantly engaged in improving its facilities and products for the purpose of keeping abreast of competitors will not meet the three tests set forth in the *Marsh Fork* opinion. Moreover, presupposing our soap case finally reached the Supreme Court, it is questionable whether that body would accept the tests as conclusive.[43] However, a decision one way or the other would go far towards clearing up the perennial question of whether and to what extent taxpayers engaging in research and development activities, just to keep abreast of the times, run a risk of a deficiency by deducting the costs of those activities.

Results of research and development known to be unsuccessful

As was pointed out in PART I, *supra,* it makes no difference taxwise whether research and development costs are deducted as "expenses" or as "losses". However, if such costs are deductible as "losses", the Bureau can require the taxpayer to *prove* absolute failure or abandonment of an experimental project during the taxable year.[44]

Results of research and development indeterminate

When the end of the taxable year rolls around, it is very often a practical impossibility to determine whether research and development activities will bear fruit.[45] In such a case, conservative business accounting requires the cost of such activities to be written off, rather than carried on the books as a valuable asset with the consequent risk of overstatement of capital.[46] On the other hand, it appears that the Bureau can *probably* require such costs to be capitalized for tax purposes. The test is said to be whether the costs are attributable to operations of the taxpayer or represent an investment in future profits.[47] And while additional work is to be done, and hope for ultimate success is not unreasonable, no part of such "investment" is supposed to be deductible.[48] Granted that the present policy of the Bureau is generally to permit research costs having indeterminate results to be deducted in accordance with established accounting procedures, the fact remains that if taxpayers think that the Bureau *can* require these costs to be capitalized, some of them will reduce or eliminate their

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[43] In Illinois Central R. R. Co. v. Interstate Commerce Commission, 206 U.S. 441 (1906), the carrier had set a rate on the basis of operating expenses which included expenditures for real estate, right of way, tunnels, bridges, and other permanent-type improvements such as locomotives and cars. The Supreme Court upheld a decision of the Commission that the rate was excessive, saying (p. 462): "It would seem as if expenditures for additions to construction and equipment, as expenditures for original construction and equipment, should be reimbursed by all of the traffic they accommodate during the period of their duration, and that improvements that will last many years should not be charged wholly against the revenue of a single year." But cf. Old Colony R. R. Co. v. Commissioner, 284 U.S. 552 (1932), where the court said that rules of accounting enforced by the Interstate Commerce Commission may not be resorted to by the Commissioner of Internal Revenue in determining tax liability.

[44] See also supra, notes 17 through 21 regarding the nature of this proof.

[45] Butters, op. cit. supra, note 8, at 456.

[46] Paton, op. cit. supra, note 10.

[47] Rabkin & Johnson, Federal Income, Gift, and Estate Taxation, E2 § 6.

[48] See Acme Products Co., 24 B.T.A. 194, 196 (1931). See also supra notes 17, 18, and 19. Even when the "ultimate success" fails to materialize the costs may not be deductible. Parkersburg Iron and Steel Co. v. Burnet, 48 F.(2d) 163 (C.C.A. 4th, 1931) (changes made in lighting conditions did not increase productivity of plant; although they probably added to the value of the plant), Cf. Edwin Dumble Co., Inc., 9 B.T.A. 591 (1927) (assessed valuation of building remained the same regardless of alterations; although they probably increased the market value of the building); Lycoming Silk Co., 11 B.T.A. 520 (1928) (rewiring of building did not prolong life of building or arrest depreciation of equipment; although it probably decreased cost of operations).

research activities. Others will feel compelled to restrict their investments in fixed assets, lest someday they be presented with an audit report showing a large deficiency as a result of their failure to capitalize such costs.

These considerations naturally lead to the question whether there is not some possibility of bringing tax accounting and business accounting together, at least on the treatment of research and development costs having *indeterminate* results. The answer depends on what interpretation a court will give to the phrase "clearly reflect the income", as set forth in Section 41 of the Internal Revenue Code.[49] If a case should come before the Court of Appeals for the Sixth Circuit, it might only be necessary for the taxpayer to prove that its method of accounting for research and development costs is *honest* and *straightforward*. Thus, in *Huntington Securities Corporation* v. *Busey*,[50] where the taxpayer had valued its inventories at cost in accordance with its established accounting procedure, the Commissioner sought to change the method of valuing inventories to market. The court refused to permit the change, holding that the taxpayer's method clearly, *though not accurately*, reflected income, and said (p. 370):

". . . If the taxpayer's method of accounting clearly reflects income, the Statute is mandatory on both him and the Commissioner that taxable income must be determined in accordance therewith. The selection of a system of accounting is lodged exclusively in the taxpayer provided it is within the statutory limits of clearly reflecting income and whatever method the taxpayer adopts must be consistent from year to year unless the Commissioner authorizes a change.

"In construing tax statutes, the familiar rule prevails that the natural and ordinary meaning of the words used will be applied unless the Congress has definitely indicated an intention they should be otherwise construed, which was not done in the Act in question here. In other words, the accepted meaning of common language should be given effect. 'Method,' as used in the present statute, means the way of keeping the taxpayer's books according to a defined and regular plan. 'Clearly,' as used in the statute, means plainly, honestly, straightforwardly and frankly, but does not mean 'accurately' which, in its ordinary use, means precisely, exactly, correctly, without error or defect."[51]

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[49] § 41 reads: "The net income shall be computed upon the basis of the taxpayer's annual accounting period . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. . . ."

[50] 112 F.(2d) 368 (1940).

[51] The Court of Appeals for the Ninth Circuit appears to be of the same opinion. In Osterloh v. Lucas, 37 F.(2d) 277 (C.C.A. 9th, 1930), the taxpayer, who reported on the cash basis, sought to deduct in 1923 a loss which was not realized in that year, although events paving the way for the loss occurred in 1923. Thus there was an attempt by the taxpayer to change its method of accounting, which the Commissioner countered by using the taxpayer's former strictly cash method in computing the deficiency. The Board of Tax Appeals held for the Commissioner, and the Court of Appeals affirmed, saying that the changed method of the taxpayer would be of "little value", inasmuch as it would enable the taxpayer to go outside of its books to show unpaid losses. On the other hand, it thought that the method contended for by the Commissioner (i.e. the taxpayer's old method) "clearly reflected income", because (pp. 278–279): "In our opinion, all that is meant is that the books shall be kept fairly and honestly; and when so kept they reflect the true income of the taxpayer within the meaning of the law. In other words, the books are controlling, unless there has been an attempt of some sort to evade the tax. This construction may work to the disadvantage of the taxpayer or the government at times, but if followed out consistently and honestly year afer year the result in the end will approximate equality as nearly as we can hope for in the administration of a revenue law."

On the other hand, if a case should come before the Tax Court, one could be fairly certain that the Court would look to its long line of precedents, commencing with the *Gilliam* and *Goodell-Pratt* cases, say that the research and development costs in question were capital expenditures, and hold that the costs could not be deducted as long as additional work was to be done and hope for ultimate success was not unreasonable. However, in 1943 the Tax Court (Judge Van Fossan) issued a memorandum opinion which at least one writer[52] has seized upon as an indication that a change may be brewing in the Court's attitude toward research and development costs. In *Pittsburgh Screw and Bolt Corporation*,[53] the taxpayer had been issued a basic propeller patent in 1929, as a result of which it formed a propeller division in its plant. From 1929 to 1938 it charged research and development costs in the amount of $392,022.99 to expense. The propeller division was sold in 1939, and, with a view to increasing the basis thereof, the taxpayer sought to capitalize the costs originally charged off, offering to make any adjustments necessary for the taxable years barred by the statute of limitations. The Commissioner's refusal to allow the basis to be so increased was upheld by the Tax Court, because "it has not been demonstrated that the proposed deferment or capitalization of all the costs in question is a better system or would more accurately reflect income." The court also said (pp. 1325-1326):

> ". . . There are many border-line cases in the matter of accounting. It may well be questioned if the best accounting practice in a business such as petitioner was conducting [viz. propeller development, production, and sale] is not to charge research and development costs to expense and if true income is not better reflected thereby. . . . It was only in 1939 when it faced a large tax on the sale of the Propeller Division assets that it was suggested that the previous system was wrong. The record does not satisfy us that the petitioner's practice, followed with the approval of the respondent during the period 1929 to 1938, was erroneous and did not accurately reflect income."

Such language by Judge Van Fossan is indeed interesting. Perhaps of greater interest, however, is the fact that in the same year the Tax Court (Judge Black) issued a memorandum opinion[54] in which it was held that expenditures incurred from 1930 to 1936 in the development of machines for magnetic testing of steel were capital; that, although previously charged off as current expenses, the taxpayer could restore them to capital; while in the following year, the court (Judge Hill) issued another memorandum opinion[55] holding that experimental expenditures resulting in patents were capital, to be exhausted over the life of the patents. Nevertheless, it must be admitted that every so often, as in the *Pittsburgh Screw and Bolt* case, one will find an enlightened statement by the Tax Court which offers a ray of hope that business accounting may yet triumph over Bureau accounting.[56] If a case involving

[52] Rice, Research and Development Costs, 1947 Taxes 41.

[53] P–H 1943 T.C. Mem. Dec. Serv. ¶ 43,414.

[54] Magnetic Analysis Corp., P–H 1943 T.C. Mem. Dec. Serv. ¶ 43,180.

[55] Viber Co., Ltd., P–H 1944 T.C. Mem. Dec. Serv. ¶ 44,332 (citing the Claude Neon Lights case).

[56] See Dusenberg, Inc., of Delaware, 31 B.T.A. 922, 926 (1934) (refusing to allow taxpayer to restore $200,000 spent from 1927 to 1929 in development and experimental work upon a new model car and charged to expense because: "The accounting and tax problems of when to treat an item as expense and when to treat it as a capital expenditure frequently depend for answer upon the circumstances of the particular case."), affd. 84 F.(2d) 921 (C.C.A. 7th, 1936); J. Bentley Squier, 13 B.T.A. 1223, 1224–1225 (1928) ("It is not possible to lay down a hard and fast rule for the determination of whether an expenditure is a capital

the deductibility of research and development costs having indeterminate results should come before the Court of Claims, it appears that the taxpayer's burden might be a little easier to sustain than it would be in the Tax Court. This is because there are practically no unfavorable precedents there, such as the *Gilliam* and *Goodell-Pratt* line of decisions in the Tax Court, and because the Court of Claims has exhibited a liberal concept of what "clearly reflects income" for purposes of Section 41 of the Internal Revenue Code.[57]

At this point it might be helpful to indicate how the burden of proof affects cases arising under Section 41 of the Internal Revenue Code. If, as in the *Pittsburgh Screw and Bolt* case, the taxpayer has made a *change* in its accounting method (e.g. in its method of treating research and development costs), then, for purposes of Section 41, there is no "regularly employed" method of accounting for such costs.[58] Thereupon, the Commissioner may employ a method (perhaps even the old method that was changed by the taxpayer) which, in his opinion, clearly reflects the taxpayer's income. The burden of proof is then on the taxpayer to show that the *Commissioner's method does not clearly reflect income.*[59] The anomaly of such a situation is that the new method to which the taxpayer has changed may clearly reflect in-

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one or is chargeable against the operating income of the year."); American Seating Co., 4 B.T.A. 649, 657–658 (1926) ("In the ordinary course of a manufacturing business the differentiation of capital expenditures and operating expense disbursements is largely a matter of sound discretion and experienced judgment."); The Sneath Glass Co., 1 B.T.A. 736 (1925) (allowing current deduction for cost of molds and patterns lasting from a day to five years because "Conservative accounting would warrant such action."). Cf. GCM 19976, 1938–1 Cum. Bull. 120, 121. ("Whether an item constitutes an expense or a capital expenditure frequently depends upon the circumstances of the particular case.").

[57] In J. I. Case Co. v. U. S., 65 F.Supp. 464 (Ct.Cls. 1946), a taxpayer on the accrual basis was allowed a deduction for taxes that had not accrued because they were attributable to the period under consideration.

[58] Cf. Capital Warehouse Co., Inc., 9 T.C. 966 (1947), where during its first two years of existence the taxpayer, on the accrual basis, sought to exclude from income the amount of a reserve for removing goods ("Reserve for Handling Out") at the end of their storage period. The Commissioner's method of computing the deficiency excluded such a reserve. The court held for the Commissioner, distinguishing Towers Warehouses, Inc., P–H 1947 T.C. Mem. Dec. Serv. ¶ 47,013, cited by the taxpayer, by stating that in the case before it there was no question of deduction in conformity with a long-established practice. In the Towers case the taxpayer was upheld in its 25-year practice of deducting a reserve for payment of labor costs of handling goods out of storage.

[59] Brown v. Helvering, 291 U.S. 193 (1934), where the taxpayer had sought to change its method of accounting in 1923 by setting up a reserve for return commissions, to be deducted in determining net income. The court, holding that disallowance of such a change was within the Commissioner's administrative discretion, said (pp. 204–205): "The Commissioner was of opinion that the method of accounting consistently applied prior to 1923 accurately reflected the income. He was vested with a wide discretion in deciding whether to permit or to forbid a change. . . . It is not the province of the court to weigh and determine the relative merits of systems of accounting." (Citing Lucas v. American Code Co., 280 U.S. 445 (1930), where the court had remarked (p. 446) that the accounting method adopted by the Commissioner should not be interfered with "unless clearly unlawful".) See also Clifton Manufacturing Co. v. Commissioner, 137 F.(2d) 290 (C.C.A. 4th, 1943), where the taxpayer proved that the Commissioner abused his discretion in using a method which added to gross income for one year interest which rightfully belonged in another; National Airlines, Inc., 9 T.C. 159 (1947), in which the taxpayer, acting under the directions of the Civil Aeronautics Board, changed its method of accounting by deferring receipts from tickets for which transportation had not actually been furnished. Citing Brown v. Helvering, supra, the court held that the taxpayer had not sustained its burden of proving that the Commissioner's method (which was the taxpayer's old method) failed to properly reflect income. In Schram v. U. S., 118 F.(2d) 541 (C.C.A. 6th, 1941), it was held that, although there was evidence that interest returned by a taxpayer on an accrual basis was not, as a matter of fact, earned during the year under consideration, the taxpayer had not refuted the Commissioner's position that the cash basis (to which the taxpayer wished to change) did not clearly reflect income. It seems that the court would have been more exact if it had held that the taxpayer failed to prove that the Commissioner's method (i.e. the accrual basis from which the taxpayer had changed) did not clearly reflect income.

come, but, unless he can *prove* that the Commissioner's method does not clearly reflect income, the cause is lost. This may be an almost insuperable task, because there are many degrees of "clearness" in the reflection of income.[60] If, as in the *Claude Neon Lights Company* case, the taxpayer has *not* changed from its regularly employed method, then the burden of proof is on the taxpayer to show that *such regularly employed method does clearly reflect income*.[61] Since, as just pointed out, there are many degrees of "clearness" in the reflection of income, it seems that such a burden would not be insuperable. Here, then, is where sound business accounting principles plus consistency in application have a real possibility of persuading a court of the propriety of deducting research and development costs having indefinite and uncertain results. This would, indeed, require acceptance of a flexible concept of "capital expenditure", to include only those costs having results which *clearly* will last substantially beyond the taxable year.[62] However, such acceptance should not be too difficult for the court if it has before it a record showing that, in the taxpayer's particular case, the capitalization of such costs would result in an *overstatement* of capital more often than their deduction would result in an *understatement* of income. Whether the Supreme Court would accept such a concept is, of course, conjectural, although that body has indicated its respect for business accounting methods.[63] In any event, a decision one way or the other would go far towards clearing up another perennially perturbing question.

PART III

How to Capitalize Research and Development Costs

Presupposing that the taxpayer is not permitted to currently charge off some or all of its research and development costs, the next question is how should they be capitalized? Although the method used must be in line with the requirement in Section 41 that it clearly reflect income, the Bureau and the courts appear to be more amenable to business accounting principles when it comes to evaluating methods of capitalizing and amortizing research and development costs. From the Bureau's standpoint, the preferable method is one in which accurate cost

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[60] Bradstreet Co. of Maine, 23 B.T.A. 1093 (1931), affd. on this point, 65 F.(2d) 943 (C.C.A. 1st, 1933), where the Board admitted that conservative accounting might justify the new method sought to be used by the taxpayer, but said that such a method was not perfect and did not more clearly reflect income than the method adopted by the Commissioner (which was the taxpayer's old method). The Board also pointedly remarked (p. 1102) that sometimes "good accounting dictates more conservatism than the necessities of income-tax reporting permit."

[61] Ross B. Hammond v. J. W. Maloney, Collector, P-H 1948 T.C. Mem. Dec. Serv. ¶ 72,522 (D.C. Ore.) (Commissioner's rejection in 1945 of accrual method, which had been adopted with his permission in 1938 and uniformly maintained since, was not warranted); Ohio Loan & Discount Co. v. Commissioner, 3 T.C. 849 (1944) (where method of accounting had been consistently employed by taxpayer for 14 years, a change in its method by the Commissioner was not permitted under § 41, I.R.C., because the record showed that the taxpayer's method clearly reflected income); Reynolds Cattle Co., 31 B.T.A. 206 (1934); Murtha v. Schmohl Co., 17 B.T.A. 442 (1929); Towers Warehouses, Inc., P-H 1947 T.C. Mem. Dec. Serv. ¶ 47,013. Of course, in the Claude Neon Lights case, the taxpayer failed to prove that its "regularly employed" method of charging off as expense the costs of research and development was clearly reflected in income.

[62] Cf. The Commissioner's concept of "capital expenditure", as set forth in § 29.41-3(2) of the Regulations: ". . . expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account."

[63] In Lucas v. Kansas City Structural Steel Co., 281 U.S. 264 (1930), the court disapproved the taxpayer's valuation of normal stock at a constant price regardless of cost or market, saying that this method ". . . does not conform with the general or best accounting methods and is apparently obsolete." But see Brown v. Helvering, 291 U.S. 193 (1934) ("It is not the province of the court to weigh and determine the relative merits of systems of accounting.")

records are maintained on each research and development project.[64] However, many businesses carry on a large amount of basic or general research in the field covered by their products which, although potentially valuable, can scarcely be assigned to specific projects; and even when the research is directed at specific products, the allocation of its cost may not be feasible because, as the results become known, they may be used in connection with several other products.[65] Under these circumstances, one method that might obtain approval would be to allocate the total cost of research and development to such projects as have been conducted during the year,[66] the allocation being on an equal basis or, perhaps, according to the relative importance of each project.[67] In turn, each allocated portion would be charged off, or capitalized and amortized, according to the results of the project to which allocated. Another method would be to lump all research and development costs together and charge them off over (1) the life of the principal patent,[68] or (2) over the 17-year life of any patents obtained as a result of the research and development activities,[69] or (3) over the average life of any outstanding patents which are benefited by the results,[70] or (4) over the average estimated useful life of any unpatented inventions or processes developed or improved by the results, or (5) over the life of a contract calling for products with which the research and development activities have been concerned.[71] An all-inclusive list of methods cannot be drawn up, for the reason that special situations call for special solutions, which the Commissioner often permits. However, one can be certain that approval of any method of charging off research and development costs will be very nearly in direct proportion to its conformity with business accounting principles.

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[64] For an excellent example of a case in which extensive cost records were maintained, see Addressograph-Multigraph Corp., P–H 1945 T.C. Mem. Dec. Serv. ¶ 45,058. The deduction of successful research and development costs was disallowed, but no question was raised over use of the cost records in determining amounts to be amortized over the lives of some 500 patents. See also page 45 of the report for an explanation of how a research project was set up.

[65] Butters, op. cit. supra, note 8, at 456.

[66] Cf. Acme Products Co., Inc., 24 B.T.A. 194 (1931) (holding that where research and development costs resulted in failure, they were properly deductible as a loss ". . . in so far as they can be properly allocated to the experimental work on these processes"). Just what was meant by "properly" was not disclosed, but the author knows of one instance where the Bureau allowed depreciation of patents based on an aggregate basis because of the difficulty of attributing basis to particular patents. Failure to allocate according to accurate cost records for each patent apparently does not preclude relief.

[67] Cf. United Profit-Sharing Corporation v. United States, 66 Ct.Cls. 171 (1928), where capitalized advertising costs were allocated to various contracts, obtained as a result of the advertising, according to the size of the contracts. Each allocated portion was then amortized over the life of the contract to which it had been allocated.

[68] Individual Towel and Cabinet Service Co., 5 B.T.A. 158 (1926); Hazeltine Corporation v. Commissioner, 89 F.(2d) 513 (C.C.A. 3rd, 1937).

[69] Magnetic Analysis Corp., P–H 1943 T.C. Mem. Dec. Serv. ¶ 43,180.

[70] Mitchell Camera Corp., P–H 1947 T.C. Mem. Dec. Serv. ¶ 47,172, affd. per curiam, 169 F.(2d) 412 (C.C.A. 9th, 1948). Cf. Simmons Co., 8 B.T.A. 631 (1927), where the taxpayer had purchased 113 patents in one group. The Board approved its annual deduction for depreciation according to the following formula:

$$\frac{\text{amount of deduction}}{\text{total cost of patents}} = \frac{\text{life of patents, as of date group was purchased, expiring during the taxable year}}{\text{total unexpired life of group on date the group was purchased}}$$

[71] The author knows of several instances in which this method has been used by charging off costs against completed production items. Amortization of capitalized research and development costs according to work in process (a sort of "percentage of completion" basis) is another variation of this method which has been permitted. However, except where income is being received on the same basis (viz. percentage of completion), this variation is not popular for obvious reasons.

New York State Tax Clinic

Conducted by BENJAMIN HARROW, C.P.A.

Survey of New York Law (1947-1948)

The November, 1948, issue of the New York University Law Quarterly Review is devoted to a comprehensive report on significant current changes in all branches of the law of New York made either by legislative enactment or by judicial interpretation of the applicable principles. One section is devoted to State and local taxation and the report is made by Henry S. Sellin. The entire issue of over 373 pages should be of interest to our members and especially the 15 pages devoted to taxation and the 43 pages devoted to labor law.

The 1948 legislature gave localities the authority to levy a tax of 3% on public utilities services to be paid by the consumer, and permitted localities to levy a tax of 5% on transient hotel accommodations costing more than $2.00 per day. The legislature gave New York City the authority to increase the tax on gross receipts generally from one-tenth to one-fifth of one percent, and on financial institutions from one-fifth to two-fifths of one percent.

The temporary reduction of 50% in personal income taxes and in taxes on unincorporated businesses was continued for another year. At this writing it is doubtful whether such reductions will be reenacted for the year 1948.

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Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is presently serving on the Society's Committees on Federal Taxation, State Taxation, Cooperation with the State Education Department and Its Agencies, and Cooperation with the Bar.

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Contract to Assume Income Tax Illegal—Section 385 of the Income Tax Law provides that

> "it shall be unlawful for any person to agree or contract directly or indirectly to pay or assume or bear the burden of any tax payable by any taxpayer under the provisions of this article."

Such a contract is null and void and under the law "shall not be enforced or given effect by any court". This section was in issue in the case of *Mahana v. Mahana.*[1] A wife brought an action against her husband based upon an agreement to pay the amount of the wife's income taxes. The Court held that the payment of additional income measured by the amount of taxes paid is not an agreement to bear the burden of another's taxes. On appeal the order was modified, the Court holding that the agreement was void only as to New York taxes.

Estate Tax—In 1946, Section 249(q) of the Tax Law was amended, limiting the exemptions in favor of spouses and children to transfers "indefeasibly vested" in the beneficiary. Four cases interpreting the words "indefeasibly vested" have come before the courts. In each case the decedent set up a testamentary trust providing for income to one member of a family with a power to invade principal for the support of the income beneficiary, the remainder to go to other members. The issue in

[1] 73 N. Y. S. (2d) 24; mod. on appeal, 272 App. Div. 1013.

each case was whether the remainderman had an indefeasibly vested transfer. Three opinions[2] construed the exemption provision strictly against the taxpayer even though it was proved in one of the cases that there would probably be no invasion of the principal, and in another that the invasion could be for the benefit of the remaindermen. In the earliest of the cases[3] the court allowed the exemption saying that "the power to invade does not affect the vesting of the estate. . . ."

Henry Sellin believes that the results are harsh and run counter to the purpose of granting exemptions to members of the family group. It would appear that the legislature will be asked to modify the language of the statute if the revenue will not be endangered thereby.

Uniformity of Administration—Two cases were decided in conformity with the federal determination. In one of them[4] the court determined the value of a widow's claim on the basis of tables relating to the rights of widows under Workmen's Compensation Acts. This widow was to receive payments until her death or remarriage. Federal courts had permitted the use of such tables.

In the other case[5] the decedent had set up an inter vivos trust in which he had a remainder interest if the beneficiary should predecease him. The decedent died in 1937 and the Federal and State law at that time did not include such trusts as part of the decedent's estate under the rule of *Helvering* v. *St. Louis Trust Co.*[6] Under the present law as determined by the United States Supreme Court in *Helvering* v. *Hallock*[7] such inter vivos transfers would of course be taxable as part of the decedent's estate. The New York courts decided the case in accordance with its policy of Federal and State uniformity in the administration of estates.

Apportionment of the Tax—Section 124 of the Decedent Estate Law requires the executor to pay the estate tax out of the estate before the estate is distributed, unless the will directs otherwise.

> "In all cases in which any property required to be included in the gross estate does not come into the possession of the executor as such, he shall be entitled, and it shall be his duty, to recover from whomever *sic.* is in possession or from the persons interested in the estate, the proportionate amount of such tax payable by the persons interested in the estate with which such persons . . . are chargeable . . ., and the Surrogate may by order direct the payment of such amount of tax. . . ."

It was held in one case[8] that an insurance company which makes payment directly to the beneficiary under a policy is not liable for the Federal estate tax apportioned to such payment. The Court held that an insurance company is not a person in possession of taxable property within the meaning of Section 124 and, also, that an insurance company is not a person interested in the estate. Mr. Sellin thinks this is a bad decision.

Professional Services v. *Commercial Sales*—Mr. Sellin calls attention to a ruling of the Special Deputy Comptroller[9] that standard engineering blue prints sold to customers by a seller of steel bars used in construction work are subject to the sales tax. Similar drawings when furnished by architects or engineers are not subject to the tax.

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[2] *Estate of Dowling*, 191 Misc. 818; *Matter of Martha M. Stubblefield*, 79 N. Y. S. (2d) 630; *Estate of Sidney Faber*, 80 N. Y. S. (2d) 380.
[3] *In re: Walsh's Estate*, 189 Misc. 350.
[4] *In re: Luke's Estate*, 75 N.Y.S. (2d) 572.
[5] *In re: Mullin's Estate*, 189 Misc. 438.
[6] 296 U.S. 39 (1935).
[7] 309 U.S. 106 (1940).
[8] *In re: Zahn's Estate*, 273 App. Div. 476.
[9] Issued October 8, 1947.

Under the sales tax law professional services are not subject to tax, whereas commercial sales are taxable.

Interest on Claims for Taxes in Bankruptcy Proceedings—In the September, 1948, issue of the State Tax Clinic (p. 608) we commented upon two Circuit Court opinions[10] on the question of when interest on claims for taxes ceases. In those two opinions the court held that interest should not accrue after the filing of a petition in bankruptcy. The conclusion of the court was that since no interest is allowed on claims having priority over taxes, and no interest is allowed on other debts, none should be allowed on claims for taxes.

Since writing the above, the United States Supreme Court on March 7, affirmed the Circuit Court's opinion. The Supreme Court places taxes in the same category as other claims on which interest is *not* allowed after the filing of a petition in bankruptcy.

Income in Respect of Decedents

Prior to the 1942 amendments to the Internal Revenue Code the final return of a decedent was required to be filed on an accrual basis regardless of the basis previously used by the decedent. In *Helvering* v. *Enright*[11] the term accrual was defined to include fees of an attorney on uncompleted cases. The 1942 amendments changed this requirement of an accrual of income where the decedent reported on a cash basis. However since this change would result in eliminating any tax on such accrued income, section 126 of the code provided that such income would be taxable to the estate of the decedent if the right to receive such income was acquired by the decedent's estate from the decedent. If by reason of the death of the decedent a beneficiary acquires the right to receive such income, then the beneficiary is subject to tax on this income. If the estate or the beneficiary disposes by sale of the right to such income, either taxpayer is subject to tax in the year of transfer on the fair market value of the right to such income plus any consideration in excess of such fair market value. The income in the hands of the estate or beneficiary retains the characteristics it would have had if the decedent himself had received it. Under section 126(c) the estate or beneficiary is entitled to a deduction for the estate tax attributable to the inclusion as an asset in the gross estate of the right to such income.

In 1944, the State of New York followed the federal changes made in 1942, with certain differences noted herein. Prior to the 1944 changes, New York State followed the federal rule with respect to the accrual of all income not theretofore reported, in the final return of a decedent.

The first difference is that under the New York law the final return of a decedent may still be filed on an accrual basis. As the Regulations put it (Art. 43),

> "If a taxpayer has died there shall also be included in computing net income and net capital gain for the taxable period in which he died amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period, regardless of the fact that the decedent may have kept his books and made his returns on the basis of cash receipts and disbursements."

But the taxpayer is given an optional method of reporting such accrued income. This method is contained in Section 358.1 of the Law and in Article 542 of the Regulations. The accrued income may be excluded from the decedent's final return if the executor who acquires the right to receive such income agrees to include it in computing the net income for the estate. If any other taxpayer acquires the right to receive the income from the decedent, such taxpayer may agree to include it in his return. Like the federal rule if the executor or other taxpayer transfers the right to receive the income for

[10] *Saper* v. *City of New York*, 168 F. (2d) 268; *Carter* v. *U.S.*, 168 F (2d) 272.

[11] 312 U.S. 636.

value, the transferor is taxable in the year of transfer on the fair market value of the right to receive the income plus any excess over such value received by the transferor. Like the federal rule the income in the hands of the executor or beneficiary retains the characteristics it would have had in the hands of the decedent.

Under the state law no deduction is allowed for the amount of estate taxes attributable to such items. The New York law contains a further requirement, viz., the filing of a bond executed by a surety company registered and under the supervision of the Insurance Department of the State of New York. The bond must be for double the amount of tax which would have been due if the accrued income had been included in the final return of the decedent.

Ordinarily income distributed to a nonresident of New York is not taxable to the nonresident. Nevertheless, under this provision of the law the nonresident beneficiary is required to file an agreement to pay the tax and a bond to assure the filing of a return and payment of the tax. Since the tax is primarily due from the decedent at the date of death the provisions of Section 358.1 will not be permitted to defeat the tax because a nonresident beneficiary receives the income.

The agreements provided in the law must be filed by all persons who under any conceivable contingency might possibly be entitled to receive some of the accrued items of income. However, no agreement is necessary if the decedent's final return and the return of the estate are filed together on the subsequent due date and all the income accrued to date of death is included in the gross income of the estate. Even in such a case an affidavit is required disclosing the facts and stating that all income accrued to the date of death has been so included. Where the estate returns 100% of the accrued income for the year during which the decedent's death occurs no bond would be required.

Computing the New York State Franchise Tax If Charitable Contributions Exceed the 5% Limitation

Bedrich F. Schonberger sends us the following easy steps for computing the tax in this situation:

In cases where the charitable contributions exceed 5% of the federal net income (computed before the deduction of such contributions and before the deduction of the New York State franchise tax), the New York State franchise tax may be computed as follows:

Step 1: The federal net income and the 5% limitation must first be determined on a tentative basis, by taking the unknown franchise tax as zero.

Step 2: Compute the tentative amount of the franchise tax. (If form 3 CT-1 is required, calculate the tax on Schedule P.)

Step 3: Multiply the tentative franchise tax by the factor which is stated below. The result is the actual franchise tax, based on a rate of 5½%.

If the business allocation percentage is 100%, multiply by 1.002757583*

If the business allocation percentage is less than 100%, multiply by............ $\left(\frac{100}{100-.275b^*}\right)$

Note that b is the business allocation percentage expressed as a decimal.

If the franchise tax has been computed under the income plus officers' salaries method and if the entire net income is allocable to New York State, multiply by 1.000725526*

* For periods subject to the 4½% rate, use 1.00225507, .225b, and 1.000675456, respectively.

Step 4: Finally, in order to obtain the deduction for contributions, reduce the tentatively deductible amount by 5% of the actual franchise tax.

More complicated methods, it should be pointed out, must be employed, if other deductible taxes are also unknown, or if certain border line cases are involved.

Deduction for Taxes—Canadian Income Tax

Isidor Sack calls our attention to an inequity in the income tax law that should receive the attention of the Tax Commission or the Legislature. A resident of New York is entitled to receive a dividend of $100 from a Canadian corporation. He actually receives only $85 since the Canadian Government withholds an income tax of 15% on the dividend. New York taxes the resident on the full $100 and allows him no deduction for the income tax.

The action of the Tax Commission is based upon Sec. 360.3 which allows a deduction for taxes

> "other than . . . income taxes, paid or accrued within the taxable year imposed, first by the authority of the United States, . . . or second, by the authority of any state. . . ."

While the law itself does not include income taxes paid to a foreign government, the Regulations (Article 141) specifically include such income taxes as being within the exception to the deduction. Also, the Tax Commission issued a ruling on June 30, 1939, that the Canadian Income War Tax in respect of dividends from Canadian corporations is not deductible and that the gross dividend is taxable.

This situation has been brought to the attention of the Tax Commission on a number of occasions. As a matter of fact, the State Tax Clinic of May, 1947, (pp. 321 and 322) had an extended comment on this issue under the caption "Double Taxation of New York Residents". We called attention to the fact that our committee had urged an amendment to Section 360(3) permitting the deduction to a resident for income taxes paid to another state. New York allows a deduction for out-of-state sales taxes or taxes on hotel rooms. In fact the legislature in 1945 amended this section to allow a credit for such income taxes provided the other state did not allow New York residents a credit against its tax for taxes paid to New York. This credit provision was repealed in 1946, because other states were encouraged to disallow credits against their taxes to New York residents. Isidor Sack himself drafted a proposed amendment that would meet the fears and objections of the State Tax Commission. We urge the Commission in the interest of eliminating a patent injustice to New York residents to give this question further consideration. The Commission does not wish to relax the rule that income taxes are not an allowable deduction from gross income. It believes that if it allowed the deduction in the case of income taxes paid to a foreign government or to any other state it would have to extend the rule to cover income taxes paid to the federal government. That would appreciably reduce the revenue and might even require an increase in tax rates to make up for such loss of revenue.

Signatures on a Joint Return

Article 521 of the regulations has recently been revised and now requires a return of husband and wife to be signed by both spouses. If one signs as agent for the other, the authorization to act as agent must accompany the return. The regulation adds that

> "the spouse acting as agent for the other shall, with the principal, assume the responsibility of making the return and incur liability for the penalties provided for erroneous, false or fraudulent returns."

Unincorporated Business Tax—Deduction for Contributions and Salary Allowance

For taxable years beginning on or after January 1, 1949, this deduction is now limited to 5% of net income computed without reference to this deduction or the deduction for salary credit. This change was made by the 1948 legislature, and Question 69 of the Regulations has been revised to reflect this change.

The proprietor's salary allowance is now limited to 20% of the net income of the corporation before considering such salary instead of 25% of gross income less ordinary and necessary expenses. This deduction is of course limited to $5,000 for each individual

member of the business. Article 13 of the Regulations as well as Question 71 have been revised to reflect this change.

Personal Income Tax Return

The status of head of a family is still recognized under the state income tax law. An individual is a head of a family if he actually supports one or more dependent persons in a home as a family unit. The dependents must be closely connected with the taxpayer by blood relationship, marriage, or adoption and the taxpayer claiming this status must have a right to exercise family control on the basis of some moral or legal obligation. The personal exemption for a head of a family is $2,500. In addition the head of a family may claim a credit of $400 for each dependent under 18 years of age and, also, for each dependent over 18 years of age if the dependent is mentally or physically incapacitated or if the dependent over 18 years of age is in full time attendance at an approved school or college. The federal law no longer recognizes the status of head of a family.

If the status of a taxpayer changes during the taxable year, the exemption is prorated on the basis of months.

Method of Payment

The normal tax and the tax on net capital gain may be paid in four equal installments. However no installment may be less than $5 except the last one. For the calendar year 1948, the due dates are April 15, 1949, July 15, 1949, October 15, 1949, and January 16, 1950. The unincorporated business tax must be paid in full with the filing of the return.

Statute of Limitation

In 1943, a taxpayer reported certain income as capital gains. In 1948, the Tax Commission determines that such income should have been taxable as ordinary income. May the Tax Commission redetermine the tax for 1943 under the provision in Section 373 that

"where there has been omitted from gross income or capital gain . . . an amount which should have been included therein and which is in excess of 25% of the amount of gross income or capital gain as so stated, the amount of tax due may be determined within five years after the return is filed."

It is our opinion that the three-year statute of limitation applies and the Tax Commission may not redetermine the tax for 1943. Gross income is defined in Section 359.1. It includes gains, profits and income derived from business, commerce or sales or dealings in real and personal property. It also includes the transaction of any business carried on for gain or profit and it also includes gains or profits or income derived from any source whatever. Prior to 1942, capital gains were taxed as ordinary income. When the law was changed in 1943, and capital gains were segregated from other items of gross income, it is our opinion that the segregation was merely for the purpose of taxing a portion of gross income at different rates. It surely was not the intention to exclude capital gains from the concept of gross income. Article 21 of the Regulations does define gross income as all income other than capital gains. But this would appear to add something that is not in the law.

When Section 373 speaks of omitting an amount of gross income or capital gain, the use of the word "or" is in our opinion in the conjunctive as well as the disjunctive. Since an item of gross income was reported as a capital gain it cannot be said that that item has been omitted from gross income. Consequently no item of income was omitted and the three year statute of limitations applies. It might also be argued that the tax return filed disclosed all items of gross income even though some of these were shown as taxable capital gains. Since they were not omitted from the return the Tax Commission had ample time within the three-year period to determine whether the items properly disclosed were taxable as capital gains or ordinary income. We should be interested in getting the comments of our members on this interesting point.

Accounting at the S. E. C.

Conducted by William W. Werntz

Buy-build-sell-lease arrangements

In the *October*, 1948, issue, we discussed briefly the deficiencies then being cited by S.E.C. in connection with lease-financing arrangements, and suggested the desirability of a general statement by S.E.C. on the subject.

In a recent address before the Delaware Society, which has been circulated in mimeographed form, Earle King, the Chief Accountant, explored the problem in some detail. His conclusions are outlined in the following excerpts:

"A recent issue of a weekly magazine describes the operations of a specialist in a form of corporate financing which has had a rapid postwar growth in popularity. 'The plan,' the article says, 'consists of selling real estate, then hiring it back from the buyer under a long-term lease, with renewal options stretching into the next century. What this amounts to is converting brick and mortar into working capital without recourse to banks or the public.' This is recognized in financial, accounting and legal circles as 'net-lease' financing and has been the subject of a limited amount of discussion in the professional press of these circles.

"There are several variations of this basic pattern indicated by the quotation above. In some cases the assets are not originally owned by the lessee, but are purchased or built to his specifications by the lessor. In some instances the financing is done directly by the lessor but in most cases it is accomplished by obtaining a loan from a third party, usually an insurance company or educational institution. The loan is secured by a mortgage on the property, and often the lease agreement is also pledged to the lender as additional security. The lessee, in the usual arrangement, is responsible for taxes, insurance, and maintenance and repair costs. There is nothing new about this aspect of the case, as a letter published last week in a Washington paper indicates. It seems that George Washington built two expensive houses near the capital in 1799 and offered them for rent at 7½% of their actual cost. The tenant, however, was to pay taxes, fire insurance and keep the property in repair.

"The 'net-lease' has three principal advantages from the viewpoint of the lessee over the more conventional method of acquiring the use of assets through purchase financed by a mortgage. First, by permitting the sale of fixed assets it furnishes a source of working capital. Second, the fact that fixed assets are converted into cash without the concurrent showing of a mortgage liability has a beneficial effect upon reported financial condition. Third, there is a tax advantage arising from the fact that the entire amount of the periodic payments under the lease is deductible as an expense, whereas only the interest portion of a payment on a mortgage is deductible for tax purposes. This latter advantage, however, is partially offset by the lessee's loss of the deduction for depreciation. It must also be considered that the lessee loses title to the property, and at the end of the lease period must either repurchase it or enter into another lease agreement. At the present time, due to the price situation, there is generally an additional advantage to the lessee in that he realizes a profit on the sale."

* * * * *

"Our requirements with respect to the treatment of 'net-lease' contracts depend upon the terms of the contracts. There are, basically, three types of contracts. Some are simple lease arrangements con-

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Mr. Werntz is the author of numerous articles which have appeared in technical accounting publications.

taining no provision for acquisition by the tenant of title to the property. Specific instructions for the reporting of long-term leases, including those of the type under discussion, are now prescribed in Item 5 of Rule 12-16 of Regulation S-X, dealing with 'Supplementary Profit and Loss Information,' which requires that the aggregate annual amount, if significant, of the rentals upon all real property now leased to the registrant and its subsidiaries for terms expiring more than three years after the date of filing, and the number of such leases, shall be stated. If the rentals are conditional the minimum annual amount thereof is to be stated. In my opinion, it is also essential, in view of the fixed committment involved, that adequate information with respect to such leases be submitted as supplemental information to the balance sheet, preferably in the form of a footnote.

"A second type of contract involves the purchase or repurchase of the property by the lessee, and provides that the periodic payments made under the agreement will be applied against the purchase price of the property. Such arrangements are, in my opinion, clearly purchase or repurchase contracts, and should be shown at their full contract cost, less appropriate allowance for depreciation, on the asset side of the lessee's balance sheet, with the liability under the purchase contract reflected under an appropriate caption on the liability side. Here, again, adequate information concerning such arrangements should be appropriately disclosed.

"The third type of 'net-lease contract' incorporates an agreement which permits but does not obligate the lessee to acquire title to the property either during the life of the lease or upon its termination. In my opinion it is necessary to go beyond the form of such contracts and determine whether, in substance, the lessee actually intends to acquire the property. Among the factors to be weighed in reaching a decision are:

1. Whether the rentals are to be applied against the purchase price, and if so, whether they are out of line with rentals under leases not containing acquisition provisions;
2. The estimated value of the property at the time the purchase option becomes exercisable as compared with the agreed purchase price, if any;
3. Whether the contract provides for an extension of the lease period, and the amount of the rentals to be paid during the extended period.

"If it is determined, after consideration of all the factors in a particular case, that the agreement is in fact a purchase or repurchase contract, it follows that it must be reflected in the balance sheet as in the second type of case. If, on the other hand, the agreement constitutes a *bona fide* lease arrangement, it will be necessary only to submit the required information as a supplement to the financial statements as in the first example.

"Another variation of the 'net-lease' procedure is the practice whereby a parent company transfers property subject to a mortgage to a wholly-owned subsidiary, and then leases back the property; in some cases the subsidiary has been created for this specific purpose. It seems to me that under these circumstances consolidated statements of the parent and such subsidiary are necessary to properly present the financial position and results of operations of the company.

"Only consolidated statements can adequately disclose the assets and liabilities of a business enterprise in which significant amounts of the fixed assets used by the parent are owned by a subsidiary.

"Most of the articles concerning 'net-lease' financing appearing in various financial and accounting publications either do not refer to the dangers inherent in this practice, or give them only passing mention. The principal danger to the lessee is, of course, the fixed commitment for a long term of years. In the cases which have come to my attention the arrangements do not appear to be subject to adjustment to conform to changes in business conditions, a situation which, in periods of declining business activity, might well become so burdensome as to cause failure of the business."

Insider profits again—bonus plans

Section 16(b) of the Securities Exchange Act of 1934 provides that a corporation may recover profits realized by so-called insiders through transactions in the issuer's securities accomplished within a period of less than six months. Profits would appear to be computed in the simple case as the difference between the amount paid for stock and the proceeds realized. In one substantial group of cases, however, the determination of the "amount paid" is not so easily made. Suppose that, pursuant to a bonus or even a direct compensation plan, certain officers are granted the right to purchase stock for cash at substantially less than market value at the time. If market value at

the date of purchase were used as a measure of the amount charged to earnings by the issuer as compensation, it would seem equitable that a similar amount should be considered as "cost" to the acquirer, so that if the stock were sold at the same price, there would be no profit subject to recovery under Section 16(b). Moreover, even should the security be sold at a price higher than the market at time of acquisition, there seems little in the reasoning underlying Section 16(b) that would require such "profits" to be subject to recovery by the issuer. Indeed, the possibility of such gains is often an inchoate part of the bonus plan and is often considered as an added incentive to the officer to improve the corporation to the benefit of all concerned.

Under Section 16, the Commission has the power to exempt transactions which it deems not comprehended within the purpose of that section. The present exemption (Rule 16B-3), relating to officers' purchases, restricts the exemption to cases in which the right to purchase was at a price not less than the market at the time the plan was adopted. Recognizing that the old rule is obsolete, in terms of modern bonus plan philosophy and practice, the S.E.C. has in Release 4216 published for comment a proposed new rule which meets the problems so far as securities acquired under bonus plans are concerned. The proposed rule reads:

"Any transaction involving the purchase and sale, or sale and purchase, of an equity security, other than a convertible security or an option, warrant or right to purchase a security, by an officer of the issuer of such security shall be exempt from the operation of Section 16 (b) of the Act under the following circumstances:

"(a) The purchase involved in the transaction was made by the officer directly from the issuer pursuant to a bonus plan approved by security holders at a meeting with respect to which proxies were solicited in accordance with Regulation X-14.

"(b) The security so purchased was acquired by the officer solely in consideration of services as an officer of the issuer.

"(c) The amount of securities so acquired by each officer pursuant to the bonus plan was subject to the discretion of an independent committee of three or more members, none of whom were entitled to participate in such plan or in any other bonus or profit-sharing plan provided by the issuer or any of its affiliates.

"(d) The aggregate amount of securities which the officer and other participants in the plan acquired pursuant to the plan was contingent upon, and computed upon the basis of, net profits of the issuer for the period in which the services of the officer were rendered."

It will be recalled that a year ago S.E.C. proposed a cognate rule in respect of purchases pursuant to options, but withdrew the proposal after studying comments received. The rule and the withdrawal were discussed in the *April* and *October* issues (1948).

Miscellany

The Commission, in Release 4220, has announced proposals for certain changes in its rules under the 1934 Act as to when-issued trading.

In Release 4215, also under the 1934 Act, certain minor changes in the forms required to be filed by National Securities Associations under Section 15A (the Maloney Amendment) were announced.

The Taxpert

By Lewis Gluick, C.P.A.

Quiz Show

The late Homer Pace, when he was publishing the American Accountant, laid down a fine editorial policy. He insisted that his writers eschew introductions. "If you have something worth saying," he preached, "say it! Don't tell why, or make excuses. Let it speak for itself." And his friendly blue pencil saved many a hundred words of typesetting, and added to the pungency of the article. But there is no rule without exceptions and the writer wants to start this "article" by telling why he is writing it.

For many years he has written much in an attempt to answer questions. This time he wants to ask them, and he is not awarding any new adding machines or cash prizes for the answers either. He just hopes that an authentic answer, or reasonable facsimile thereof, will appear, to be passed on to the thousands of readers of this publication.

Everybody knows that the taxpayer is required to make returns, and that if he refuses to do so, the Commissioner may do so for him. *Question:* May the Collector refuse to accept a return? A correspondent claims that it has been done to one of his clients, and did the Shoptalker ever hear of such a thing? That last is easy. No! Of course, the Commissioner has been upheld by the courts in asserting that returns not properly signed and sworn to, are not returns at all. But, if the return is proper in those respects, may he refuse to accept it? Well, there is only one case the writer can think of and that would be an amended return *after* an agent has started a fraud examination.

Another highly technical question, on which the regulations or instructions are silent (or the writer blind) is tied up in 117j. Certain assets are described as capital assets; and certain assets are described as not being capital assets. Then, under certain described circumstances, gains on non-capital assets may be *treated* as if the assets were capital assets. Please note the italics. The nature, for income tax purposes, is not changed. Only the treatment thereof. The question is, "Where do you show such gains on the tax return; Schedule D of 1040, for example?" If the writer has been asked that once, he's been asked that fifty times in this last tax season. He replies that if the asset is subject to a depreciation allowance, then, by definition, it is not a capital asset. Therefore, it belongs in the block at the bottom of the form. To which nearly everyone replies that, since the gain is to be taken into account at only 50%, it should go up among the long-term capital gains. No doubt about it, for calculation purposes the latter is easier. But technically, is the writer right? What do you do in your practice? Attach a separate schedule, without bothering to classify it? That's evading the issue.

Similarly, we are faced with a badly designed form for reporting expenses deductible above the line. An amateur, trying to find a space to deduct honest-to-goodness away-from-home traveling

Lewis Gluick, C.P.A., has been a member of the Society since 1924. He has recently resumed the practice of accountancy in the East, and been reappointed to the Committee on Accounting Machinery, of which he was chairman in 1939 and 1940.

He is best known as the *Shoptalker*, under which name he has been writing since 1928.

expenses can't find any specific place to do it. Some try to fit them into Schedule C. The collector may accept the return, but he won't accept that place. Slightly more complicated are expenses incurred in earning partnership income but which, by agreement, must be borne by the individual partner. How do you readers get them on the returns you make? And why don't we all get together and politely ask Mr. Schoeneman to make a better form?

Now here is one last one, which we have heard batted around chiefly on the grounds of ethics. What should you do when the taxpayer cannot or will not give you full details for medical expenses? The regulations and instructions are perfectly plain that the name and address of every physician, dentist, nurse, optometrist or faith healer must be stated together with the amounts paid each. Which seems eminently fair. But the vast majority of taxpayers seem to think that such details are to be ignored, and scold the accountant for asking for them.

Should then a C.P.A. insist on getting the details and putting them down on page 3; and perhaps, lose the client? Or may he take the client's word for it, and cover himself with the thought that he has used "all the facts of which he has knowledge," and let it go at that?

AN ADIRONDACK VIEW

What a Mess! Not you but us. We of the Adirondacks are supposed to furnish the residents of the State of New York with Week-ends in the Snow. The week-ends came every seven days, but the snow never arrived. We wrote to a member of the Buffalo Chapter about it last Christmas and he said, "It is on the way". (You know all the weather we get in these mountains comes from Buffalo.)

The bob-sled run has to be built of snow—wet and frozen. The World Championships were scheduled. Snow had to be carted in from up on Whiteface Mountain. One team went off the top at Shady, one man was killed.

The ski slopes were a mess too. All slope and no ski! Those who ski are very fussy, they insist on more than an inch or two of snow.

But if you think we are a mess, look around a bit. Go to Washington—they ski not, nor bob-sled, nor legislate either—they filibuster. Go to Albany—they don't even filibuster! The budget and tax bill slammed into the wall at Shady, stopped short (bang!), the team got all messed up, the driver found himself in the middle, and the brake found himself and another fellow hanging on to the steering wheel. What a mess! New York income taxes for last year not decided upon by March 15th, and we poor devils having to accrue these taxes for Federal deductions

We don't blame you for pitying us in the Adirondacks, Washington, and Albany for our sodden situations, and laughing at us, too. All right, "laugh, fool, laugh," look at yourself; perhaps you are in a bit of a mess yourself, and don't know it! Did you take a few days off after March 15th in order that you might get back to somewhere near normal again? The writer did.

Leonard Houghton, C.P.A.
of the Adirondack "Chapter"

BOOK REVIEWS

Company Annual Reports—To Stockholders, Employees and the Public

By Thomas H. Sanders. HARVARD BUSINESS SCHOOL, Boston, Mass., 1949. Pages: xiii + 338; $3.75.

In view of the present wide-spread interest in corporate reports, this study of current attitudes and practices is a timely addition to the literature in the field. Add to this the fact that the author is a distinguished accountant, writer and teacher, and the book becomes an essential addition to any library of business subjects.

The material is divided into three parts. The first part deals with underlying considerations, the president's report, the financial statements, and the use of statistics, charts, graphs and pictures; it concludes with the author's summary and conclusions. The second part covers the views of the various parties in interest—company managements, investment analysts, labor unions, employees, and stockholders—as evidenced by letters and by the results of company questionnaires. The third part discusses trends in accounting practices and the degree of "acceptance" actually enjoyed by generally accepted accounting principles.

The factual material underlying the study seems to be adequate; the summarizing and analysis have been competently done. Particular mention should be made of the skill with which the presentation has been arranged. Realizing that all parts of the study would not be of equal interest to all readers, the author has made possible optional selections by those who have a particular interest in one phase of the matter or another. For those who do not wish to read the entire work at one sitting, the arrangement lends itself readily to use as a reference when specific phases of the general problem are under consideration. In its entirety the book is a clear and comprehensive presentation of the problems and practices in the field of corporate annual reports.

The study was made possible by an allocation of funds contributed by the Associates of the Harvard Business School thereby demonstrating once more the possibilities of joint efforts by business and schools in the matter of business research.

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Handbook of Cost Accounting Methods

Edited by J. K. Lasser. D. VAN NOSTRAND COMPANY, INC., New York, N. Y., 1949. Pages: vii + 1344; $12.00.

Once again, J. K. Lasser has brought his organizing genius to bear upon the production of this excellent handbook, of which he is the editor. Seventy contributors have been brought together in the undertaking, each a distinguished authority in his own field who is thoroughly conversant with modern developments and the latest methodology. These authors are men who have had responsible experience with important and intricate cost accounting problems during World War II, and who have seen the field emerge, refined and improved, from the rigorous testing ground of wartime conditions. Their approach in this handbook is the utilization of cost accounting as a means of helping management to do a better job.

Section I is entitled, "The Art of Cost Accounting." It begins by explaining the nature of costs and the principal problems of cost accounting. The various uses of cost accounting—as an instrument of pricing; in controlling inventories and storeroom; in making the most effective use of men and machines; and in controlling variations, forecasting and planning—are then treated in detail. Next, the techniques, controls and procedures involved in the cost accounting process are discussed and the methods of reporting are considered in the light of the type of cost system in use. The subject of system design and installation follows, and the section closes with three chapters on distribution costs, cost practices, and the impact of government on cost accounting.

Section II deals with applications of cost accounting in sixty-one particular industries, each presentation following the same basic pattern: (a) a description of the business; (b) methods of designing the cost system; and (c) a presentation of a tested cost system, with accompanying forms, charts, tables, reports, statements, etc.

Section III contains 52 pages of bibliographical references for additional study. An adequate index completes the volume.

Mechanically, the production is good and the volume will be easy to read and use. This reviewer predicts a big sale of this book among accountants, industrial engineers, and business executives.

EMANUEL SAXE